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EDITORIAL

Stock Overvaluation Condemned

Sufficient attention has not been given to a decision of the federal trade commission rendered by the commission after consideration of a registration statement filed September 1, 1933, in the case of the Unity Gold corporation. The decision was of importance for several reasons, and we believe that accountants generally would be interested in reading the finding of the commission. In brief it is stated that the "registration statement includes untrue statements of material facts and omits to state material facts required to be stated therein and necessary to make the statements therein not misleading . . . This contention extends also to the prospectus, in so far as it contains information relating to the subject matter of these items." The items mentioned consist of three. The commission did not find any cause for exception to other points which had been raised. It appears that on July 15, 1931, a group of mining claims was acquired by one, King, under a royalty lease for three years. King also acquired an option to purchase the property before the expiration of the lease for $15,000, royalties to apply on the purchase price. The stated consideration for this option was $1.00 and the acceptance and performance of the lease. He thus acquired the use and control of the claims at no expense other than the usual obligations to operate the property and to pay royalties on the proceeds. Thereafter, King organized the Industrial Gold Mining company and assigned to it the lease and option in consideration of the issuance to him of 2,000 shares of stock having a par value of $1.00 a share. The Industrial company expended about $5,560 in developing the property but produced no gold and hence paid no royalties. "Desiring further capital, King published an advertisement . . . which was answered by R. L. Maxwell. Negotiations ensued, culminating in the assignment of the lease and option to the Unity Gold corporation. . . . The alleged deficiencies in the registration statement arise from the description of this transaction and the significance to be attached to it as determining the cost of the property." In subsequent transactions it appears that the original cost was described as cash $5,000 and 599,995 shares of capital stock, a total of $604,995. Abstract fees were added, which produced a ledger value at the end of 1932 and at the end of September, 1933, $605,047. It was contended by the government that these figures were untrue in three respects. First, they included shares paid to promoters by the registrant for services rendered to it. Second, it included 475,000 shares which were "donated back" to the registrant in the same transaction. Third, the shares included in the purchase price were taken at the par value of $1.00 a share whereas their fair value as shown by sales was said to be much less.

Bookkeeping Not a Basis of Value

The commission's finding asserts that accounting theory and practice reveal some disagreement as to whether promotion expenses are properly to be regarded as representing capital assets or should be treated as a deferred or prepaid expense, but there is no disagreement that expense in the nature of promoters' fees should be listed separately from expenditures representing the amount paid for physical property. Dealing with the question of 475,000 "donated" shares, the commission says: "That these 475,000 shares could not be regarded as being part of the cost of the lease and option on the ground that the registrant parted with these shares in order to obtain the property seems hardly open to question. The donation back to the registrant of these shares was concurrent with the purchase of the property itself. The Industrial company by the terms of the purchase contract had no jus disponendi at any time over these shares. No evidence was adduced to show that even the form of transfer and retransfer was followed. That it was merely a bookkeeping transaction is evidenced by the records of the Industrial company itself, for one need only turn to the minutes of this company to find the president reporting that 'the deal as closed consummated the sale of all the assets of the Industrial Gold Mining Company to the Unity Gold Company (sic) for the sum of $5,000 in cash and 15,560 shares of capital stock of the Unity Gold Company, par value $1.00 per share.' The purpose of a transaction of this type—pretending to a transfer and retransfer of capital stock as between purchaser and vendor—is primarily to attempt to make the stock fully paid and non-assessable so that thereafter it can be sold as such at any price without making purchasers of the stock liable to the corporation's 'creditors.'" We understand that the opinion in this case was written by James M. Landis, who was then chairman of the federal trade commission and is now one of the securities exchange commissioners. We feel that Commissioner Landis deserves high commendation for the soundness of the decision and for his ability to sweep aside any dependence upon precedent and to go to the very heart of the matter. There have been many cases brought to the attention of accountants, in addition to those which have found their way into court, wherein the same principle of excessive valuation of property has been defended on the ground that it was a custom of the mining industry. We are not at all sure that these allegations are true. There may have been many cases in which such a practice was adopted, but to say that it was an invariable custom of the industry is going rather too far. At any rate, there seems to be no justification whatever for an attempt to report the value of a company's stock at a figure far above any market price, simply because of bookkeeping entries which should have offset each other in the calculation of value. It is the accountant's duty to state the facts, and if the figures presented for his investigation and approval do not fairly represent the facts we can not believe that there is any excuse for accepting a method of computation of which he disapproves. As an eminent member of the Institute said with reference to this case at a recent meeting of the council: "Because a thing has been sanctioned in the past is no justification for continuing an evil practice."

Custom Not Sufficient Justification

There will probably be wide differences of opinion as to the extent to which it is the accountant's right to challenge the action of directors in assigning a value to property. The accountant is not charged with the duty of placing a value upon assets unless he finds that there is obvious misrepresentation. In other cases less clear than the present one, the accountant is confronted by a rather serious problem as to his rights and duties. As an illustration of the difficulty of determining value, a correspondent writing upon the Unity Gold decision says, "In the case of a patented process which is acquired by a corporation in exchange for a block of its capital stock which has no market value, the directors may honestly place thereon a valuation of substantial amount based upon the knowledge of the directors of the industry to which it applies and its potential earning power. It is difficult to conceive that in any such situation the accountant could form an opinion contrary to that of the directors. Nevertheless, within a short period thereafter some new process might be developed which would render valueless the one which the corporation had acquired. Thereupon the stock might be sold at a very much smaller figure than the value which the directors attributed to it in the first instance." The same correspondent says again, "After all, as far as the accountant is concerned, is it not a question of full disclosure of all the facts? Certainly his statements will not be misleading if he discloses clearly in a case like this that a certain value was put on the property by the directors and that this value represented the par value of the stock issued for the property, that a certain number of shares of such stock was subsequently donated to the company and that a certain amount was realized from the sale of those shares. The accountant in such a case is not a valuer but is only a reporter." We have great respect for the correspondent whose expressions we have just quoted, but we can not agree that in a case like that which was properly decided by the federal trade commission, the accountant would be justified in accepting a valuation more or less arbitrarily selected by the directors. The accountant is more than a reporter. If he were merely that there would be little difference between bookkeeping and accounting. The accountant is charged with the duty of determining whether the report which he renders is or is not based upon what he believes to be a true presentation of fact. In other words, he is an analyst. The federal trade commission went to the root of the matter, and we believe that most accountants who have had experience in the problems of mine accounting will regard the decision with hearty approval.

Independent Audits of Railway Accounts

The Chicago and Indiana Railroad Company recently made application to the committee on stock list of the New York stock exchange for the listing of 8,722,000 first and refunding mortgage, 5½ per cent. bonds, due September 1, 1962. The listing application in general followed the usual form and was approved by the committee on stock list. One noteworthy innovation, however, calls for comment. In the agreement the railroad company undertakes among other things, "that all financial statements in future annual reports sent to stock holders or published after three months from the date of this application shall be audited by independent public accountants qualified under the laws of some state or country and shall be accompanied by a certificate of such public accountants showing the scope of such audit and qualifications, if any, made by them in respect thereto." This is apparently the first application for listing by a railroad company which conforms to the new requirements of the stock exchange. Heretofore the following footnote appeared in listing agreements of railroad applications, "In view of the fact that the ——— company keeps its accounts under the regulations of the interstate commerce commission and furnishes balance-sheets, income statements, etc., to that commission as required by it (as well as to its stock holders) and its accounts are subject at all times to inspection and examination by that commission such action is understood to be a full compliance with these agreements."

An Important Innovation

Without in any way impugning the value of the interstate commerce commission's supervision, it can be confidently affirmed that the value of independent audit has never been properly recognized by railroads generally until the present time. Supervision by the interstate commerce commission is necessarily more or less perfunctory and not analytical. The commission's inspection does not run to detail except in rare instances, and the consequence has been that railroad shareholders have not been given one of the most important aids to the valuation of their securities. There has never seemed to be any good reason why railroads should be exempt from the common requirement of business that there shall be thorough audit. The magnitude of the task of railroad audit is not sufficient excuse for avoidance. There are other industries in which audit is more difficult. There are many professional accountants who are well qualified to conduct investigation of the condition of railroads and to provide a mass of illuminating information which will enable investors and prospective investors to form a better judgment of the worth of securities. The New York stock exchange is to be highly commended for its insistence upon independent audit of all companies whose securities are offered for listing. A further evidence of the beneficent influence of the stock exchange is found in the decision of some of the greatest oil companies to submit their accounts to impartial audit. The whole trend toward greater investigation and better exposition of facts is encouraged by the wisdom of the stock exchange authorities, aided in no small way by the powers of the securities exchange act. The transportation industry of this country is one of the greatest of all, and as its financial affairs come under the scrutiny of professional accountants another heavy burden of responsibility is being laid upon accountancy. The railroad audits will call for a substantial increase in the activity of public accountants throughout the country, and we are confident that they will render in this industry, as they have in countless others, an invaluable service to the public and to the cause of better business.

Care for the Future Investor

Everyone knows that the national securities act and the securities exchange act and many other little acts not quite so ostentatious are primarily designed to protect the future investor. Congress and the government—or perhaps one should say the government congress—are properly exercised about the necessity of full and frank explanations and presentations of fact relative to all stocks, bonds and other media of investment which are offered to the public. No one can reasonably protest against reformation where it is needed, and it seems probable that the net effect of the recent enactments will be considerably beneficial. The iniquities which naturally creep into zealous legislation will be largely overcome in administration or in amendatory acts. Some of the ambiguities and most of the injustices will be removed. There may be some unfortunate consequences of the wave of reform, but looked at in the large the result will be chiefly good, unless—and there is some danger here—the administration drift into the hands of utterly impractical theorists or political protégés. While these acts were in the making there was a great deal of misrepresentation. The outcry against Wall street was magnified through all the loud speakers of the land. Unfortunately most people believe what they hear. This is an incomprehensible truth, but a truth nevertheless. A man speaking over a national network of radio can make almost any wild statement which comes to his mind and a few million people will believe it. So it was that when Wall street was described as the colossus of theft and when bankers were catalogued as malefactors, many of the people who listened were not sufficiently alert to attempt to distinguish between the false and the true. And while the great preachment against financiers was being uttered there was an extraordinary failure to mention another and perhaps a larger class to which protection should also be extended.

Why Forget Investors in Esse?

It is not only the future investor who has need of shepherding. The people who have invested have some rights, unless we misunderstand the constitution of the United States. (The Journal of Accountancy is one of the old-fashioned believers in the sanctity of the constitution and in its longevity. It will survive all the obstreperous but ultimately puny attempts to destroy it.) Men, women, children, institutions and all the great army of investors who have invested deserve some protection. So far there has been little evidence that they have been considered at all. Yet it seems to us bad politics, which is a very sound basis of appeal in these days, to overlook the rights of the people who have something to lose. When all is said and done, they must be the first to help put money into circulation. But when their dollar of investment is arbitrarily cut forty per cent., and when there is threat of further debasement of their assets, and when taxes, which must be levied upon those who have rather than upon those who have not, are leaping upward, it seems that the time has come for turning attention, for a few moments at least, to the protection of existing wealth. Of course, it would be unjust to suggest that legislators and administrators who are so busily engaged in protecting the man who may have something some day are saying privately among themselves: "Let us not worry about the man who has invested; we have his money where we can debase it and ultimately ruin him. Now let us induce others to invest, so that in process of time we shall have other resources upon which to exercise our predatory talents." That, we repeat, would be quite unthinkable.

The Land of Dreams Some one, who must have a sense of humor, has sent us a pamphlet, published in California, which describes the great panacea for which the world has waited since man appeared out of the jungle. It is so simple that one is amazed at the thought that it has never been discovered before. Every dreamer of a new republic from Plato onward has been concerned with the problem of caring for the elderly, but no one, so far as we can remember, has put forward a definite plan of such simplicity as that which the pamphlet before us describes. As we understand the idea, it is merely to pay to every citizen, male or female, throughout the land, who has attained the age of sixty years and has never been convicted of a felony, a pension of $200 a month until death, upon the sole condition that he take oath to spend for goods or services the entire amount of the pension within the confines of the United States during the month in which it is received and shall refrain from all remunerative or productive occupation. Naturally, the question may arise as to where this vast sum is to be obtained. The answer is as simple as the first part of the plan. All we shall need will be a ten per cent. sales tax. It is stated that huge amounts are disbursed every month in purchases and therefore the ten per cent. tax would yield a sum believed to be sufficient for the payment of the general pension. We confess that we can not quite follow the argument at this point, but that is evidently due to the fault of a somewhat incredulous mind. The plan is delightful in contemplation. One has only to imagine the product of a sales tax immediately put into circulation by means of purchasing and thereby becoming subject to another tax and so on, ad infinitum. Apparently, no consideration is to be given to the effect of a ten per cent. sales tax upon the volume of sales. It seems that buyers would be quite as willing to pay $11 as to pay $10—at least they should be, in the interest of humanitarianism. This plan, let it be known, is apparently put forward in all seriousness; but there may be a skeptic here and there who will need to be convinced before the consummation which the authors of the plan devoutly desire. It serves to show, however, how excursions into the realm of vain imaginings go on and on. The building of castles in Spain is unending, and it probably does no particular harm except to give a few people a distorted sense of pragmatic possibilities. We are in a time of visions, but some day, as has always happened in the past, there will be a return out of the mists to the clear highway which leads somewhere.

Annual Meetings of Accountants

The annual meeting of the Dominion Association of Chartered Accountants was held at Montreal, September 4th to 7th inclusive, and accountants who were fortunate enough to be present report that it was of exceptional interest. The American Institute of Accountants was represented by its president and its secretary and the Institute of Chartered Accountants in England and Wales was represented by H. L. H. Hill, a former president of that institute. The traditional hospitality of Canada was amply manifest. Indeed, the meetings of the Dominion Association are becoming increasingly important in the annals of accountants throughout the entire North American continent. There is the closest coöperation between the accountants of Canada and the United States and it is difficult to distinguish between the purposes, accomplishments and practices of these two national organizations. At every meeting of the American Institute there is a welcome delegation from Canada, and on the United States side of the border many accountants look forward each year to the opportunity to visit the accountants of Canada. All this makes for the advancement of the profession throughout the continent, and we congratulate the Canadian accountants upon the uniform excellence and enthusiasm which characterize their meetings. It is appropriate to direct attention anew to the dates of the annual meeting of the American Institute of Accountants, which will be held in Chicago, October 15th to 18th inclusive. All members of the Institute have been notified that special rates on the railroads are available until the end of October when the Century of Progress exposition comes to an end. Full information about hotel and railroad rates, etc., may be obtained from the secretary of the American Institute of Accountants. We strongly urge every accountant, whether a member of the Institute or not, to attend the open sessions of the Institute meeting.

An Ancient Audit Certificate

An esteemed correspondent, who takes an interest in things ancient as well as modern, sends us a copy of a certificate of audit which he discovered in St. David's Church, Radnor, Pennsylvania. The certificate reads as follows:

"October ye 8th, 1736.

"Hugh Hughes, treasurer to ye congregation of St. David's Church produced his accepts, when it appeared to us whose names are under written yt. he ye said Hugh Hughes disposed of all such sums of money as he recd. being eight pounds fourteen shillings and eleven pence according to ye order and direction of ye Reverend Mr. Hughes then Missionary and congregation.

(Signed)	Griffith Hughes, Cler.	Thomas Godfrey
	William Davies	Isaac Wayne
	his	Evan David
	Peter (P. E.) Elliott	his
	mark	Edward (E) Williams
	his	mark
	James (J) David	his
	mark	Edward (X) George, Sen.
	his	mark
	Morris (M) Griffith	John Jones
	mark	George James"

There are several points about this audit report which are noteworthy. It will be seen that even in 1736 some auditors felt that a certificate was merely an expression of opinion, because here we find that "it appeared to us." This is probably the prototype of "in our opinion." There is also a bit of unconscious humor in the last three words of the certificate. According to a little pamphlet history of old Saint David's, the Reverend Mr. Hughes was not very popular and it was quite possible that on wintry days he was literally his own congregation. The third point which should not be overlooked is that even in 1736 some of the auditors could write their own names.

Liability of Accountants Under Securities Exchange Act of 1934

(INCLUDING AMENDMENTS TO SECURITIES ACT OF 1933)

By Spencer Gordon

At a meeting of the American Institute of Accountants at New Orleans, October 17, 1933, a paper was read entitled *Accountants and the Securities Act.* This dealt with the problems of accountants under that statute, the origin and extent of their responsibility, the defenses available to them in case of suit and the extent of their liability. The address was afterwards published in The Journal of Accountancy for December, 1933.

Title 2 of the securities exchange act of 1934 (which I shall call the 1934 act) contains certain amendments to the securities act of 1933 (which I shall call the 1933 act) which make substantial changes in the liability of accountants under that statute. Without repeating what has already been said in the article *Accountants and the Securities Act*, I shall here attempt to state what these changes are. Title I of the 1934 act also imposes certain new liabilities, and I shall discuss these briefly.

Amendments to Securities Act of 1933

Prima-facie case

In any action against an accountant under section 11 of the 1933 act, before the recent amendments, the plaintiff must sustain the burden of proof that there has been, in the part of the registration statement attributed to the accountant, an untrue statement of a material fact or the omission to state a material fact required to be stated in the registration statement or necessary to make the statements therein not misleading, and the plaintiff must also sustain the burden of proof that he has acquired such security, and that the accountant has with his consent been named as having prepared or certified the statement which is the subject of the suit. If the plaintiff establishes these facts, the burden of proof is then imposed on the defendant to establish the defenses allowed under section 11 (b), which have been discussed fully in the paper *Accountants and the Securities Act.*

Section 206 of the 1934 act amends the securities act of 1933 as follows:

"Sec. 206 (a), section 11 (a) of such act is amended by adding after the last line thereof the following new sentence: "If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.'"

This provision is self-explanatory and adds another requirement which must be met by the plaintiff in such cases as fall with the amendment. The burden is on the plaintiff to make the proof required. This amendment is thus beneficial to accountants.

Proof of Belief in Certain Cases

In the article *Accountants and the Securities Act* attention was called to the fact that in a balance-sheet or profit-and-loss statement certified by an accountant there may be items as to which he indicates that he in turn has relied upon another expert, or that the accountant's certificate may in part purport to be a statement made by an official person or a copy of or an extract from a public official document.

The provisions of the statute have been changed in regard to such cases. Section 206 (b) of the 1934 act amends section 11 of the 1933 act as follows:

"(b) Clauses (C) and (D) of paragraph (3) of section 11 (b) of such act are amended to read as follows: '(C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.'"

Before the amendment the 1933 act read:

". . . he had reasonable ground to believe and did believe . . . that the statements therein were true and that there was no omission . . . or . . . that such part of the registration statement fairly represented . . . or was a fair copy . . ."

The change of language from positive to negative will apparently result in defendants' being held in the middle class of cases where there was reasonable ground to believe that the statements were true and that there was no omission, or that they fairly represented, or were fair copies; but there also existed some reasonable ground for believing the contrary. In such cases defendants would have escaped liability under the 1933 act, but will be held under the amendment. To put it simply, it seems to me that it will be more difficult to sustain the burden of proof that there has been no reasonable ground to believe a statement untrue than to sustain the burden of proof that there has been reasonable ground for believing it true. (Arthur H. Dean, in *Fortune* September, 1934, disagrees with this view, but it seems to me that the burden now required of defendants under clauses (C) and (D) is very similar to the burden of proof imposed on the state in criminal cases, to prove beyond a reasonable doubt.)

It should be noted, however, that there has been no change in the language of section 11 (b) (3) (B) of the 1933 act which deals with the situation that usually is presented in a suit against an accountant. This section remains as follows:

". . . as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert"; (Section 11 (b) (3) (B).)

Standard of Reasonableness

In the article *Accountants and the Securities Act* the standard of reasonableness provided by section 11 (c) of the 1933 act was discussed. By section 206 (c) of the 1934 act this subsection has been amended to read as follows:

"'(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.'"

This amendment is an improvement in that it removes the doubtful language of the former section that "the standard of reasonableness shall be that required of a person occupying a fiduciary relationship."

Damages

The section of the 1933 act in regard to damages has been completely changed by the 1934 act to read as follows:

"(d) Subsection (e) of such section 11 is amended to read as follows:

"'(e) The suit authorized under subsection (a) may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: *provided*, that if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. . . . In any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.'"

This amendment removes the ambiguous language of section 11 (e) of the 1933 act which was discussed at length in the article *Accountants and the Securities Act.* The amended section seems reasonably clear. The recovery of the consideration paid for the security is eliminated, and liability is restricted to the recovery of damages measured by losses the basis of which is clearly set forth and not left to conjecture as in the 1933 act. The amendment further restricts the damages to

"the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading. . . ."

but places the burden on the defendant on this point. The court may require an undertaking from and may assess costs and attorney's fees against the defendant as well as against the plaintiff.

This amendment to section 11 (e) of the 1933 act is a decided improvement from the standpoint of the accountants, and it takes care of much of the criticism of the 1933 act. The provision as to burden of proof is disappointing but is relatively unimportant compared to the clarification of the damage question and restriction of damages to depreciation in value resulting from the misstatement or omission.

Section 11 (g) of the securities act of 1933 becomes nugatory in view of the provisions of the amendment to section 11 (d).

Limitation

By section 207 of the 1934 act, the provisions as to limitation on suits are changed to read as follows:

"No action shall be maintained to enforce any liability created under section 11 . . . unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . In no event . . . more than three years after the security was bona fide offered to the public."

By the 1933 act, the limitations had been two years and ten years respectively.

Reliance on Regulations

Section 209 (b) of the 1934 act amends the 1933 act as follows:

"(b) Subsection (a) of such section 19 is further amended by adding at the end thereof the following new sentence: 'No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the commission, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.'"

No such provision was contained in the 1933 act, and this amendment should be effective in protecting an accountant who relies on the rules and regulations of the commission.

Liability Under Securities Exchange Act of 1934

Up to this point I have been discussing the 1934 act only so far as it amended the 1933 act. There is also in the securities act of 1934 an express provision regarding liability arising under that statute as follows:

"Sec. 18. (a) Any person who shall make or cause to be made any statement in any application, report, or document, filed pursuant to this title or any rule or regulation thereunder, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant.

"(b) Every person who becomes liable to make payment under this section may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment.

"(c) No action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued."

It seems to me that this section 18 (a) of the 1934 act is less drastic and more equitable than the rather involved provisions of the 1933 act, even as now amended. Some of the differences are the following: (1) Under the 1934 act the statement must be at the time and in the light of the circumstances in which it was made false or misleading with respect to a material fact. Under the 1933 act, as amended, a suit may be instituted

"in case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

(2) Under the 1934 act the person suing must have acted "in reliance upon such statement." Under the 1933 act as amended, reliance is required only

"If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement."

(3) Under the 1934 act only "damages caused by such reliance" can be recovered. This is perhaps also true under the involved language of the 1933 act as now amended, but the burden is placed on the defendant to show that the damages claimed did not result from the statement.

(4) Under the 1934 act, the defendant may escape liability by proving that he "acted in good faith and had no knowledge that such statement was false or misleading." In the article *Accountants and the Securities Act* and in this article I have discussed the rather involved defenses under the 1933 act.

An Accounting Perspective of Society

By Edmond Gattone

In the present era of world-wide economic distress and the consequent experimentation to rehabilitate and coördinate the forces of production and consumption, it becomes of paramount importance that the nature and relationship of such basic concepts as wealth, savings, profits and income be clearly defined and understood. Here, I believe, the accountant has a fertile field for research and constructive thought. As the science of accountancy has correlated to a degree of exactitude the property, income, expenses, obligations and ownership of an individual business or chain of affiliated businesses, so it would seem that this same science could be extended to show with mathematical clarity the balanced relationship in a society of its wealth, distribution of wealth, social institutions and economic activity. Today, of course, relatively meager and inadequate sources of statistical information would make the practical execution of such a plan virtually impossible. Nevertheless, I believe a theoretical discussion of procedure would be justified if for no other purpose than to demonstrate the potential application of accounting methods as an aid to the solution of social and economic problems.

This discussion will of necessity be based on a hypothetical case. Because of the extensive scope of such an analysis, the limitations of space will permit the assumption of relatively few facts and a very broad and general classification of social institutions and economic activity.

We shall commence with a society having a total population of 1,000 persons. This society has been organized into a political community or state. The functional agencies of the state will be known as the government. As the economy of the social system is essentially laissez-faire, or individualistic, the activities of the government do not transgress the field of private initiative, but are confined to such constituent functions as national defense, administration of justice, regulation of property rights, coinage of money, etc.

The economic activity of the society may be summarized into three very broad classifications as follows:

1. Production.
2. Distribution.
3. Banking and credit.

Production consists of all processes combining human labor with technological skill and equipment and designed to transform natural resources either directly or indirectly into consumable goods and services. In this sense production includes all phases of agricultural and industrial activity such as farming, animal raising, mineral extraction, forestry, manufactures, power generation, building construction, transportation of raw materials and goods in process, etc. All production activities of the society are vested in private ownership and for the sake of simplification will be grouped into a single business unit known as "production industries."

The functions performed by those enterprises handling, buying and selling, marketing and merchandising the finished goods turned out by the production industries are defined as distribution. As here used, distribution includes the operations of wholesalers, retailers, commission merchants, etc., and the storage and transportation of finished goods. The ownership and management of distribution facilities are vested in private interests and for the purpose of simplifying the discussion all distribution activities in the society will be grouped into a single business unit known as "distribution enterprises."

To fill the need for elastic credit, essential to a highly organized system of exchange, and to serve as a depositary for surplus funds, a banking institution has been organized. Pertinent facts relating to the economic conditions of the society at the beginning of our period of review, say, January 1, 1926, are as follows:

Exhibit 1

The government
Balance-sheet, January 1, 1926

Assets

Gold bullion held in trust against gold certificates—contra	$ 40,000
Bank deposit	2,000
Foreign government loans	10,000
Gold certificates held in trust to redeem bank notes—contra	600
3½% government bonds held in trust to secure bank notes—contra	12,000
Public improvements and properties—250 units	250,000
Total	$314,600

Liabilities

Gold certificates outstanding secured by gold bullion—contra......	$ 40,000
Greenback currency outstanding............................	23,000
Public debt—evidenced by 3½% interest-bearing bonds........	155,850
Liability for gold certificates held in trust to redeem bank notes—contra..	600
Liability for 3½% government bonds held in trust to secure bank notes—contra......................................	12,000
Surplus..	83,150
Total..	$314,600

Exhibit 1 sets forth the financial condition of the government as at January 1, 1926, and the status of its trust funds as of that date. All gold bullion in the society has been deposited in trust with the government treasurer and gold certificates (a kind of money or currency) have been issued against such deposits. The gold certificates are redeemable on demand in gold specie. The status of the gold bullion trust is depicted by the following items in exhibit 1:

Asset:

Gold bullion held in trust against gold certificates—contra......	$40,000

Liability:

Gold certificates outstanding secured by gold bullion—contra....	$40,000

The banking institution is empowered to issue bank notes (another kind of money or currency) on condition that an equal face amount of government bonds, together with gold certificates equal to 5 per cent. thereof, be deposited as security for such issue with the government treasurer. The status of the trust securing the bank circulation is described as follows in exhibit 1:

Assets:

Gold certificates held in trust to redeem bank notes—contra.....	$ 600
3½% government bonds held in trust to secure bank notes—contra..	12,000

Liabilities:

Liability for gold certificates held in trust to redeem bank notes—contra..	$ 600
Liability for 3½% government bonds held in trust to secure bank notes—contra......................................	12,000

A third kind of money in circulation in the society consists of greenbacks or legal tender notes issued by the government. This greenback currency, although not secured by a specific fund, is protected by the general taxing powers of the government.

The liability of the government for this greenback issue is denoted in exhibit 1 as follows:

Greenback currency outstanding	$23,000

In order to finance the construction and acquisition of public improvements and properties deemed necessary to efficient governmental administration and the public welfare, the government has floated long-term interest bearing bonds. The total amount of this bonded indebtedness is shown in exhibit 1, as follows:

Public debt—evidenced by 3½% interest-bearing bonds	$155,850

The quantitative inventory of public improvements and properties has been designated in exhibit 1 as "250 units," the cost value of which is $1,000 per unit, or $250,000.

To meet the emergencies arising in a past warfare, loans to the amount of $10,000 were granted to allied foreign governments. These loans bear interest at the rate of 5 per cent. per annum, payable in gold.

The $2,000 current operating fund of the government, as is indicated by exhibit 1, has been deposited with the banking institution.

The excess of the government's assets over its liabilities amounts to $83,150 and has been denoted as surplus in exhibit 1. Each member of the society has an equal, nontransferable, beneficial interest in the government's surplus. The ownership of this beneficial interest, although real, is not evidenced by an instrument or certificate in writing, as is usually the case with other classes of property rights.

Exhibit 2

The bank

Balance-sheet, January 1, 1926

Assets

Gold certificates in vault	$ 39,400
Loans	60,000
Gold certificates deposited in redemption fund with government treasurer	600
3½% government bonds deposited with government treasurer to secure note circulation	12,000
Total	$112,000

Liabilities

Deposits	$ 74,000
Circulation	12,000
Capital stock	20,000
Surplus	6,000
Total	$112,000

Exhibit 2 is a statement of resources and liabilities of the banking institution as at January 1, 1926. The law of the society has prescribed gold certificates as the legal reserve for the bank and such reserve is not to be less than 10 per cent. of the outstanding deposit liability. In exhibit 2 it will be noted that gold certificates in the vault as at January 1, 1926, aggregated $39,400, as against deposits of $74,000, or a reserve ratio of 53.24 per cent.

As already mentioned, the circulation of bank notes must be secured by an equal amount of government bonds, together with a 5 per cent. redemption fund deposited with the government treasurer. The status of the bank's circulation, together with the trust funds set aside as security therefor, is described as follows, in exhibit 2:

Assets:	
Gold certificates deposited in redemption fund with government treasurer	$ 600
3½% government bonds deposited with government treasurer to secure note circulation	12,000
Liabilities:	
Circulation	$12,000

It will be noted from exhibit 2 that the loans of the banking institution aggregated $60,000 on January 1, 1926. As an increase in loans is offset by a corresponding increase in deposits, or a withdrawal of cash, the over-extension of bank credit is held in check by the minimum legal reserve requirement.

The capital stock of the bank is privately owned and the stockholders' equity, which is represented by capital stock and surplus aggregating together $26,000, serves as a margin of safety to depositors.

Exhibit 3

Production industries balance-sheet, January 1, 1926

Assets	
Bank deposits	$ 30,000
Production equipment and properties—800 units	800,000
Natural resources—750,000 units	750,000
Total	$1,580,000
Liabilities	
Notes payable—bank	$ 50,000
6% bonds payable	150,000
Capital stock	1,380,000
Total	$1,580,000

Exhibit 3 sets forth the financial condition of the production industries as at January 1, 1926. All natural resources of the society such as land, mineral deposits, forest reserves, water power, etc., are privately owned by the production industries. The quantitative inventory of these resources has been designated in exhibit 3 as 750,000 units, the value of which is $1 per unit or $750,000.

All tools, technological equipment, and building structures used in production activities are also owned by the production industries and, as will be noted in exhibit 3, aggregate 800 units valued at $1,000 per unit, or $800,000.

Partly to finance the acquisition of natural resources and the construction of plant and equipment, bonds to the amount of $150,000 have been floated. The balance of the financing has been completed through the sale of capital stock, which aggregated $1,380,000.

Although the working capital of the production industries amounts to $30,000 and has been supplied through the medium of bank credit, the relative bank obligation aggregates $50,000 and constitutes a floating debt to the extent of $20,000.

Exhibit 4

Distribution enterprises balance-sheet, January 1, 1926

Assets	
Bank deposits	$ 8,000
Consumable goods—150,000 units	150,000
Distribution facilities—225 units	225,000
Total	$383,000

Liabilities

Notes payable—bank	$ 10,000
Capital stock	373,000
Total	$383,000

The finished goods and services turned out by the production industries are marketed or distributed to the persons comprising the society by the distribution enterprises. To perform the functions of distribution certain facilities are necessary, such as sales buildings, display counters, showrooms, warehouses, delivery vehicles, etc. These distribution facilities as set forth by exhibit 4 aggregate 225 units valued at $1,000 per unit or $225,000.

The merchandise inventory carried by the distribution enterprises consists of goods wholly processed and ready for human consumption. It will be noted from exhibit 4 that the consumable goods on hand at January 1, 1926, amounted to 150,000 units valued at $1 per unit or $150,000.

Aside from the fact that a portion of the working capital has been procured through bank credit, the distribution enterprises have been financed solely through the medium of capital stock, all of which is privately owned.

THE POPULATION

As has been previously mentioned, the population of the society consists of 1,000 persons. For the sake of simplification, the economic class structure of the population may be divided into two very broad groups as follows:

	Number
Investor class	100
Worker class	900
Total	1,000

The investor class comprises persons who have supplied the necessary capital to operate the private enterprises and therefore are vested with the legal ownership, control and management of such enterprises. Whether the investors accumulated their capital through the medium of honest savings, speculative profits or other methods is not material in this discussion.

The worker class is composed of all persons engaged in skilled or unskilled occupations, whose primary source of income is derived from wages or salaries earned from such occupations.

The employment of the worker class is distributed as follows in the society:

	Number employed
The government	26
The bank	3
Production industries	820
Distribution enterprises	51
Total	900

Exhibit 5 is a balance-sheet of January 1, 1926, of the investor class. This balance-sheet was constructed by combining or consolidating the balance-sheets of all the persons comprising that class. Exhibit 6 is a balance-sheet of January 1, 1926, of the worker class and was also prepared by combining or consolidating the balance-sheets of all the workers in the society.

Exhibit 5

Investor class—100 persons
Balance-sheet, January 1, 1926

Assets		
Bank deposits		$ 2,000
Greenback currency		3,000
Stocks owned at book values:		
Bank	$ 26,000	
Production industries	1,380,000	
Distribution enterprises	373,000	1,779,000
Production industries 6% bonds at par		150,000
Total		$1,934,000
Liabilities		
Net worth		$1,934,000

As will be noted from exhibit 5, the investor class owns all the outstanding capital stock of the production industries, the distribution enterprises and the bank. Through the medium of this stock ownership this class is vested with direct control of the production, distribution and credit facilities within the society, subject of course to certain prescribed governmental regulations.

All the outstanding bonds of the production industries are also owned by the investor class. It might be observed that a relatively small proportion of the resources of the investor class is kept in liquid form, i.e., in the form of cash and bank deposits.

Exhibit 6

Worker class—900 persons
Balance-sheet, January 1, 1926

Assets

Bank deposits	$ 32,000
Greenback currency	20,000
Bank notes	12,000
3½% government bonds	143,850
Total	$207,850

Liabilities

Net worth	$207,850

From exhibit 6 it will be noticed that the resources of the worker class are highly liquid, consisting of bank notes, greenback currency, bank deposits and government bonds. The exigencies of day-to-day existence do not permit this class, with its relatively limited surplus, to risk the hazards of more speculative investments.

SOCIAL WEALTH

In considering wealth in a social sense it is important to distinguish between the physical objects of wealth and the superstructure of claims existing against such objects of wealth. Claims for wealth bear a dual position, being at once an asset to the claimant and a liability to the obligor. When both the claimant and the obligor are members of the same society, then the claim asset of one is offset by the claim liability of the other and, in a social sense, no wealth or obligation exists. However, should the claimant and the obligor be members of different societies, then the claim is at once wealth to one society and an obligation to the other.

Exhibit 7 is a summary of balance-sheets showing the manner of combining and consolidating the wealth of all the institutions and persons comprising the society on January 1, 1926. All claims for wealth wherein both the claimant and the obligor are members of the society have been eliminated in the column headed, "Intra-society eliminations." It will be noted that such items as bank deposits, loans, gold certificates, bank notes, greenback currency, trust accounts, bonds and stocks constitute

Exhibit 7

The society balance-sheets, January 1, 1926

	The government	The bank	Production industries	Distribution enterprises	Population: Investor class	Population: Worker class	Intra-society eliminations	Social balance-sheet
Assets								
Gold bullion	$ 40,000							$ 40,000
Deposits in bank	2,000		$ 30,000	$ 8,000	$ 2,000	$ 32,000	$ 74,000 (A)	
Gold certificates		$ 39,400					39,400 (B)	
Gold certificates—redemption fund		600					600 (C)	
Gold certificates in trust	600						600 (B)	
Greenback currency					3,000	20,000	23,000 (D)	
Bank notes						12,000	12,000 (E)	
Government bonds						143,850	143,850 (F)	
Government bonds—with treasurer		12,000					12,000 (G)	
Government bonds—in trust	12,000						12,000 (F)	
Loans		60,000					60,000 (H)	
Foreign government loans	10,000							10,000
Production industries—6% bonds					150,000		150,000 (I)	
Stocks at book values					1,779,000		1,779,000 (J)	
Consumable goods—150,000 units				150,000				150,000
Distribution facilities—225 units				225,000				225,000
Production equipment and properties—800 units			800,000					800,000
Public improvements and properties—250 units	250,000							250,000
Natural resources—750,000 units			750,000					750,000
Totals	$314,600	$112,000	$1,580,000	$383,000	$1,934,000	$207,850	$2,306,450	$2,225,000
Liabilities								
Gold certificates outstanding	$ 40,000						$ 40,000 (B)	
Greenback currency outstanding	23,000						23,000 (D)	
Circulation		$ 12,000					12,000 (E)	
Notes payable—bank			$ 50,000	$ 10,000			60,000 (H)	
Deposits		74,000					74,000 (A)	
Liability for gold certificates in trust	600						600 (C)	
Liability for government bonds in trust	12,000						12,000 (G)	
6% bonds payable—production industries			150,000				150,000 (I)	
Public debt	155,850						155,850 (F)	
Capital stock		20,000	1,380,000	373,000			1,773,000 (J)	
Surplus	83,150	6,000					6,000 (J)	$ 83,150
Net worth					$1,934,000	$207,850		2,141,850
Totals	$314,600	$112,000	$1,580,000	$383,000	$1,934,000	$207,850	$2,306,450	$2,225,000

mere offsetting claims for wealth and form no part of the social wealth. However, in the case of foreign government loans, as the obligor (a foreign government) is not a member of the society under review, such loans are a part of the social wealth. As shown by exhibit 7 in the column headed, "Social wealth," the balance of the items constituting the actual wealth of the society are the natural resources, public improvements, production equipment, distribution facilities, inventories of consumable goods and gold bullion.

DISTRIBUTION OF WEALTH

Having determined what constitutes social wealth, we may next consider its distribution among the persons in the society and the particular claims for wealth evidencing and affecting this distribution. In the society under review, both persons and institutions are owners of claims for wealth. Obviously, however, the claims for wealth owned by persons determine the distribution of social wealth and not the claims for wealth owned by institutions. Hence, each person's share in the social wealth is measured and evidenced by the amount of his bank deposits, currency, bank notes, bonds and shares of stock.

Exhibit 8

Social balance-sheet, January 1, 1926
Social wealth

Gold bullion	$ 40,000
Foreign government loans	10,000
Consumable goods—150,000 units	150,000
Distribution facilities—225 units	225,000
Production equipment and properties—800 units	800,000
Public improvements and properties—250 units	250,000
Natural resources—750,000 units	750,000
Total	$2,225,000

Distribution of wealth

Ownership of worker class (900 persons) evidenced by:		
Bank deposits	$ 32,000	
Greenback currency	20,000	
Bank notes	12,000	
Government bonds at par	143,850	
900/1000ths of government surplus	74,835	$ 282,685

Ownership of investor class (100 persons) evidenced by:		
Bank deposits	$ 2,000	
Greenback currency	3,000	
Stocks at book values	1,779,000	
Production industries 6% bonds at par	150,000	
100/1000ths of government surplus	8,315	$1,942,315
Total		$2,225,000

Exhibit 8 has been designated a "social balance-sheet" and purports to show the actual wealth of the society, its distribution and the claims for wealth affecting this distribution. It is important to notice that to account for all wealth the beneficial interest in the government's surplus, shared equally by all, has been included among the claims for wealth. As an estimate of the value of this item would serve no practical purpose, it is generally ignored in the preparation of a person's balance-sheet.

It will be noted from exhibit 8 that of the total social wealth valued at $2,225,000, $282,685, or 12.7 per cent., is owned by the worker class and $1,942,315, or 87.3 per cent., is owned by the investor class. The aggregate value of the bank deposits, bank notes, greenback currency, bonds, stocks and government surplus, owned by all the persons in the society is equal to the aggregate value of the social wealth.

Economic Activity

The next phase of discussion concerning the society will deal with its economic activity during the calendar year 1926 and the effect of this activity on the social wealth of the close of the year. Pertinent facts concerning activities during 1926 may be reviewed in the following order:

THE GOVERNMENT

The sources of governmental revenues are twofold, consisting of taxes levied on domestic industries and enterprises and interest collected on loans granted to foreign governments. Disbursements are appropriated for departmental salaries and wages, interest on the public debt and the construction of public improvements. The government balanced its budget for the year 1926, as will be observed from the following:

Budget—for the year 1926

Receipts:	
Taxes	$45,954.75
Interest on foreign loans	500.00
Total	$46,454.75

Expenditures:

Departmental salaries and wages	$39,000.00
Interest on the public debt	5,454.75
Public improvements—2 units	2,000.00
Total	$46,454.75

As will be recalled, the number of governmental employees is 26 and the average annual salary of each employee amounts to $1,500, or $39,000 in the aggregate. Interest on the public debt is paid at the rate of 3½ per cent. per annum.

During the year the government awarded contracts to the production industries for the construction of two units of public improvements at a total contract price of $2,000.

A statement of the government's income and expense for the year 1926 is as follows:

Exhibit 9

The government
Summary of income, year 1926

Income:		
Taxes	$45,954.75	
Interest on foreign loans	500.00	
Total		$46,454.75
Expenses:		
Departmental salaries and wages	$39,000.00	
Interest on the public debt	5,454.75	
Total		44,454.75
Net income		$ 2,000.00

It will be noted that the government enjoyed a net income of $2,000 during the year, which increased the surplus from $83,150 at the beginning of the year to $85,150 at the end.

THE BANK

Practically all business transactions of institutions, as well as of persons in the society were consummated through the mechanism of banking facilities, i.e., by the deposit and drawing of cheques. At the close of the year 1926 the bank's resources showed an increase of $222,500, which consisted of the following:

Increase in gold certificates in vault	$ 2,500
Increase in loans	220,000
Total	$222,500

The increase in gold certificates is accounted for by the transfer of gold bullion into the society from foreign countries in settlement of the following items:

Interest on foreign government loans	$ 600
Net excess of exports over imports	2,000
Total	$2,600

Upon receipt of the gold bullion, the government treasurer issued $500 gold certificates to the government and $2,000 gold certificates to the distribution enterprises. These certificates were accordingly deposited in the bank.

To finance purchases of consumable goods made by the distribution enterprises from the production industries, bank loans to the distribution enterprises were increased by $220,000 during the year.

A statement of the bank's income and expense for the year 1926 follows:

Exhibit 10

The bank
Summary of income, year 1926

Income:	
Interest on loans	$11,900
Interest on government bonds	420
Foreign exchange service charges	300
	$12,620
Expense:	
Salaries and wages	4,500
Net income	$ 8,120
Dividends paid to stockholders	3,000
Undivided profits	$ 5,120

Three employees are engaged by the bank at an annual salary cost of $1,500 for each employee, or $4,500 in the aggregate. Interest was not paid on deposits because all deposits are payable on demand.

It will be noted that the bank's income was derived from interest on loans and government bonds and charges made for foreign exchange services. Of the net income of $8,120, $3,000 was paid to stockholders as a dividend and the balance was carried as undivided profits.

PRODUCTION INDUSTRIES

The activities of the production industries may be divided into two basic operations as follows:

1. Direct production of consumable goods and services.
2. Indirect production, i.e., the construction of capital equipment, tools, improvements, etc.

During 1926 the production industries gave employment to 820 persons at an average salary or wage cost of $1,500 per annum, or $1,230,000 for the total number employed. This total wage or labor cost may be allocated to direct and indirect production as follows:

Labor costs applicable to direct production of consumable goods..	$ 964,230
Labor costs applicable to construction of improvements, facilities and equipment	265,770
Total	$1,230,000

During the year the production industries extended their own plant and equipment by 250 units and, under duly awarded contracts, constructed two units of public improvements for the government and twenty units of distribution facilities for the distribution enterprises. Total labor costs for construction during the year may be divided among these three classes of extensions as follows:

	Labor costs
Production equipment—250 units	$249,600
Public improvements—2 units	1,470
Distribution facilities—2 units	14,700
Total	$265,770

To finance the construction of its 250 units of production equipment, the production industries floated $250,000 par value 6 per cent. bonds. These bonds were subscribed by the worker class.

The total cost of the 250 units of production equipment consists of the following elements:

Labor	$249,600
Depletion of natural resources	400
	$250,000

Statement of operations of the production industries covering the year 1926 follows:

Exhibit 11

Production industries

Summary of operations, year 1926

	Construction government—2 units	Contracts distribution enterprises—20 units	Consumable goods—1,288,000 units	Total
Sales	$2,000.00	$20,000.00	$1,288,000.00	$1,310,000.00
Cost of sales:				
Labor	1,470.00	14,700.00	964,230.00	980,400.00
Depletion	.90	9.00	590.10	600.00
Depreciation	72.00	720.00	47,208.00	48,000.00
Taxes	371.43	3,714.37	20,676.70	24,762.50
Less, consumable goods in process	......	......	(25,000.00)	(25,000.00)
Total cost of sales	$1,914.33	$19,143.37	$1,007,704.80	$1,028,762.50
Gross profit on sales	$85.67	$ 856.63	$ 280,295.20	$ 281,237.50
Interest expense:				
Notes payable				$ 3,500.00
Bonds payable				17,125.00
Total interest expense				$ 20,625.00
Net profit for year				$ 260,612.50
Dividends paid to stockholders				230,000.00
Undivided profits				$ 30,612.50

It will be observed from exhibit 11 that the major portion of gross profits earned by the production industries was derived from the production and sale of 1,288,000 units of consumable goods. These goods were sold directly to the distribution enterprises and not to consumers. The entire selling price was collected for all but $50,000 of consumable goods sold. This uncollected amount was charged to an open account to the distribution enterprises.

A net profit of $260,612.50 was earned during 1926, from which $230,000 dividends were distributed to stockholders, leaving $30,612.50 undivided profits in the industries.

DISTRIBUTION ENTERPRISES

All consumable goods and services produced within, exported from or imported into the society are marketed to consumers by the distribution enterprises. It will be observed from exhibit

12 that the 1,636,000 units of consumable goods available for sale or consumption during 1926 were disposed of as follows:

	Units
Sold to domestic population (workers and investors)	1,024,000
Exported	160,000
Unsold (closing inventory)	452,000
Total	1,636,000

During the year the distribution enterprises exported 160,000 units of domestic goods at an aggregate selling price of $200,000 and imported 198,000 units of foreign goods at an aggregate cost of $198,000. As will be recalled, the net trade balance of $2,000 was settled by the transfer of gold bullion into the society.

At the close of 1926 the distribution enterprises had increased their inventories of domestic and imported goods by 302,000 units. The purchase of this increased inventory was financed by bank borrowings and through open credit extended by the production industries.

In conjunction with increased trade activities, the distribution enterprises expanded their distribution facilities by twenty units. These additional units were constructed by the production industries at a total contract price of $20,000.

The total number of persons employed by the distribution enterprises was 51 and the average salary for each employee amounted to $1,500 per annum, or $76,500 in all.

It will be noted from exhibit 12 appearing on following page that the distribution enterprises enjoyed a net profit of $176,807.75 for 1926 and paid $140,000 dividends to stockholders. The balance of earnings, amounting to $36,807.75, was retained in the enterprises as undivided profits.

THE POPULATION

The money income of the population under review was derived from the following sources:

1. Wages and salaries.
2. Interest on bonds.
3. Dividends in stocks.

It is important to distinguish the money income from the real income inuring to the members of society. The real income consists of the total units of consumable goods and services actually

Exhibit 12

Distribution enterprises—Summary of operations, year 1926

	Domestic goods		Imported goods		Total	
	Units	Money value	Units	Money value	Units	Money value
Gross sales:						
Worker class	720,000	$ 900,000	None	None	720,000	$ 900,000.00
Investor class	208,000	260,000	96,000	$120,000	304,000	380,000.00
Exports	160,000	200,000	None	None	160,000	200,000.00
Total	1,088,000	$1,360,000	96,000	$120,000	1,184,000	$1,480,000.00
Cost of goods sold:						
Beginning inventory	150,000	$ 150,000	None	None	150,000	$ 150,000.00
Purchases	1,288,000	1,288,000	198,000	$198,000	1,486,000	1,486,000.00
Total goods available for sale	1,438,000	$1,438,000	198,000	$198,000	1,636,000	$1,636,000.00
Less, ending inventory	350,000	350,000	102,000	102,000	452,000	452,000.00
Total cost of goods sold	1,088,000	$1,088,000	96,000	$ 96,000	1,184,000	$1,184,000.00
Gross profit on sales		$ 272,000		$ 24,000		$ 296,000.00
Expenses:						
Wages						$ 76,500.00
Depreciation						13,500.00
Taxes						21,192.25
Foreign exchange service						300.00
Interest on notes payable						8,400.00
Total expenses						$ 119,892.25
Net profit for year						$ 176,107.75
Dividends paid to stockholders						140,000.00
Undivided profits						$ 36,107.75

consumed during a given period. The amount of this real income for a society is measured by the cost of living of all the people comprising its population. To increase this real income either immediately or in future periods should be the ultimate objective of all economic activity and legislation regulating economic affairs.

Exhibit 13

Investor class—100 persons
Summary of income, year 1926

Income:		
Dividends on stocks	$ 373,000.00	
Interest on production industries—6% bonds	9,000.00	
Total		$ 382,000.00
Cost of living:		
Domestic goods consumed—208,000 units	$ 260,000.00	
Imported goods consumed—96,000 units	120,000.00	
Total		380,000.00
Direct savings		$ 2,000.00
Indirect savings:		
Increase in book value of stocks owned:		
Production industries—undivided profits	$ 30,612.50	
Distribution enterprises—undivided profits	36,107.75	
The bank—undivided profits	5,120.00	71,840.25
Total savings		$ 73,840.25

Exhibit 14

Worker class—100 persons
Summary of income, year 1926

Income:		
Wages and salaries	$1,350,000.00	
Interest on bonds	13,159.75	$1,363,159.75
Cost of living:		
Domestic goods consumed—720,000 units		900,000.00
Total savings (direct)		$ 463,159.75

Exhibits 13 and 14 set forth the money income, real income, and savings for 1926 of the investor class and the worker class respectively. From these exhibits it will be observed that the direct savings of the population consist of money income received

Exhibit 15

Society balance-sheets, December 31, 1926

	The government	The bank	Production industries	Distribution enterprises	Population: Investor class	Population: Worker class	Intra-Society eliminations	Social balance-sheet
Assets								
Gold bullion	$ 42,500							$ 42,500
Deposits in bank	2,000		$ 34,612.50	$ 5,607.75	$ 4,000.00	$245,159.75	$291,380.00 (A)	
Gold certificates		$ 41,900					41,900.00 (B)	
Gold certificates—redemption fund		600					600.00 (C)	
Gold certificates in trust	600						600.00 (B)	
Greenback currency					3,000.00	20,000.00	23,000.00 (D)	
Bank Notes						12,000.00	12,000.00 (E)	
Government bonds						143,850.00	143,850.00 (F)	
Government bonds—with treasurer		12,000					12,000.00 (G)	
Government bonds—in trust	12,000						12,000.00 (F)	
Accounts receivable			50,000.00				50,000.00 (H)	
Loans		280,000					280,000.00 (I)	
Foreign government loans	10,000							10,000
Production industries—6% bonds					150,000.00	250,000.00	400,000.00 (J)	
Stocks at book values					1,850,840.25		1,850,840.25 (K)	
Consumable goods (domestic)—350,000 units				350,000.00				350,000
Consumable goods (imported)—102,000 units				102,000.00				102,000
Goods in process—100,000 units			25,000.00					25,000
Distribution facilities—245 units				245,000.00				245,000
Production equipment and properties—1,050 units			1,050,000.00					1,050,000
Public improvements and properties—252 units	252,000							252,000
Natural resources—750,000 units			750,000.00					750,000
Totals	$319,100	$334,500	$1,909,612.50	$702,607.75	$2,007,840.25	$671,009.75	$3,118,170.25	$2,826,500
Liabilities								
Gold certificates outstanding	$ 42,500						$ 42,500.00 (B)	
Greenback currency outstanding	23,000						23,000.00 (D)	
Circulation		$ 12,000					12,000.00 (E)	
Notes payable—bank			$ 50,000.00	$230,000.00			280,000.00 (I)	
Deposits		291,380					291,380.00 (A)	
Accounts payable				50,000.00			50,000.00 (H)	
Liability for gold certificates in trust	600						600.00 (C)	
Liability for government bonds in trust	12,000						12,000.00 (G)	
6% bonds payable—production industries			400,000.00				400,000.00 (J)	
Public debt	155,850						155,850.00 (F)	
Reserve for depreciation			48,000.00	13,500.00				$ 61,500
Reserve for depletion			1,000.00					1,000
Capital stock		20,000	1,380,000.00	373,000.00			1,773,000.00 (K)	
Surplus	85,150	6,000					6,000.00 (K)	85,150
Undivided profits		5,120	30,612.50	36,107.75			71,840.25 (K)	
Net worth					$2,007,840.25	$671,009.75		2,678,850
Totals	**$319,100**	**$334,500**	**$1,909,612.50**	**$702,607.75**	**$2,007,840.25**	**$671,009.75**	**$3,118,170.25**	**$2,826,500**

during a given period and not converted into real income during that period. Undivided profits of corporations during a given period and enhancing the book values of their outstanding stocks constitute indirect savings to the owners of these stocks, as is shown by exhibit 13.

The total savings of the worker class, amounting to $463,159.75 for the year, were invested as follows:

Deposited in bank	$213,159.75
Invested in production industries 6% bonds	250,000.00
Total	$463,159.75

The savings of the investor class were principally of an indirect nature; however, the total savings of this class amounting to $73,840.25 for the year, are accounted for as follows:

Deposited in bank	$ 2,000.00
Increase in book value of stocks owned (undivided profits)	71,840.25
Total	$ 73,840.25

EFFECT OF ACTIVITY

Exhibit 15 sets forth the closing balance-sheets as of December 31, 1926, of all the institutions and classes of population in the society and the resulting social wealth after eliminating intra-society items. On comparing this exhibit with exhibit 7, it will be observed that the total social wealth has increased during 1926 by $539,000 (after allowance for depreciation and depletion). The nature, source, and ownership of this increased wealth may be set forth as follows:

Exhibit 16

Summary of increased social wealth, year 1926
Nature of increased wealth

Gold bullion	$ 2,500
Consumable goods (domestic)—200,000 units	200,000
Consumable goods (imported)—102,000 units	102,000
Goods in process—100,000 units	25,000
Distribution facilities—20 units	20,000
Production equipment and properties—250 units	250,000
Public improvements and properties—2 units	2,000
Total	$601,500
Less, reserves for depreciation and depletion	62,500
Net increase in social wealth	$539,000

Source and ownership of increased wealth

Ownership of worker class (900 persons) derived from:		
Direct savings:		
Increase in bank deposits	$213,159.75	
Increased holdings of production industries 6% bonds	250,000.00	$463,159.75
Indirect savings:		
900/1000ths of increase in government surplus		1,800.00
Ownership of investor class (100 persons) derived from:		
Direct savings:		
Increase in bank deposits		2,000.00
Indirect savings:		
Increase in book value of stocks owned (undivided profits)	$71,840.25	
100/1000ths of increase in government surplus	200.00	72,040.25
Total		$539,000.00

It will be noted from exhibit 16 that the actual physical increases in wealth consist of additional quantities of gold bullion, consumable goods, goods in process, distribution facilities, production equipment and public improvements (less reserves for depreciation and depletion). The sources of this increased wealth arose from direct savings of the population, undivided corporate profits (indirect savings) and an increase in the government's surplus (indirect savings). Of the total increase in wealth, $464,959.75 inured to the worker class and $74,040.25 to the investor class.

Let us now examine more closely the items constituting the increased social wealth, for the purpose of ascertaining to what extent the society is building its prosperity on a sound basis. The first item of increased wealth set forth in exhibit 16 is "gold bullion $2,500." It will be recalled that this increase in gold arose as a result of the following:

Settlement of a favorable trade balance	$2,000
Collection of interest on foreign government loans	500
Total	$2,500

As the supply of gold in the world is limited, it can not be expected that foreign societies will be able to effect gold settlements on their debts for an indefinite time. Consequently in order to be assured of a continued prosperity based on foreign trade and foreign loans, the society should look forward to receiving settlements of net balances in forms of wealth other than gold which it can not duplicate within its own political boundaries.

The next three items of increased social wealth consist of consumable goods—domestic, imported, and goods in process—all of which have an aggregate money value of $327,000. In general, it may be stated that the accumulation of consumable-goods inventories is a hazard to the continued economic well-being of a society. Under a competitive-price system the dangers of drastic price reductions to dispose of surplus inventories and the concomitant evils of curtailed production are too well known to require comment. In such circumstances it would be far better for business to earn smaller profits and for persons to accumulate less savings in order to effect the consumption of consumable goods than to risk disruption of the entire economic machinery. Consumption is real income in the final analysis and is the end toward which all economic activity should be directed. The accumulation of consumable-goods inventories or the curtailment of production is justified only when complete satiety of economic wants is enjoyed by everyone in a society.

Production equipment and distribution facilities were increased during 1926 by 270 additional units, which have been valued at $270,000. If this expansion of equipment and facilities was made to provide for wants of the population not capable of being satisfied with existing facilities, then the expansion has been a healthy one and the prosperity has been built on a sound base; however, if existing equipment was adequate to meet these wants, then the expansion has been wasteful and the prosperity is illusory. Future returns on this class of equipment and facilities will not be sufficient to justify the capital investment.

Public improvements, which have been increased by two units at a total cost of $2,000, are basically sound in the economic growth of society provided these improvements contribute materially to the efficiency of governmental administration. However, should the improvements add little to governmental efficiency or to the betterment of the public welfare, then this class of expenditures hardly seems justified.

From the foregoing discussion it will be seen that the direct savings, undivided profits and governmental surplus accumulated during a given period have a physical counterpart in various units of wealth created during that period. Although these units of wealth are valued in monetary terms at the direct cost of production or acquisition, plus gross profits realized on subsequent transfers or sales, this monetary valuation is not necessarily indicative of the future returns that will be earned on each wealth unit. Future monetary returns depend upon the nature of the units of wealth created; hence an over-valuation of wealth units results in an over-statement of savings, undivided profits and governmental surplus and conveys a false notion as to the extent of the economic progress made during a period of activity.

In general, the economic activity of society during a given period may be reduced to the following objectives:

1. The production of goods and services to meet the requirements of current consumption.
2. The creation of additional units of capital wealth to offset depreciation and depletion charges on existing wealth and to provide for the expanding wants of the population.

The accomplishment of these objectives may be considered as a postulate of prosperity, for, without the attainment of both, the social and economic machinery of society can not function smoothly. For example, where the foreign trade balance is even and all activity is devoted to the direct production of consumable goods and services, and the total domestic output and current imports are sold to the population at an aggregate sales price equivalent to the aggregate money income of the population, business and industry will find a deficit for the period, due to book charges for depreciation and depletion. If, to offset depreciation and depletion charges, the domestic output and current imports are sold at an aggregate price greater than the current money income of the population, then the result will be merely a transfer of wealth from one group of the population to another group and will in no way counterbalance both the decrease in social wealth and the corresponding impoverishment of that group within the population spending beyond its current money income. Thus we see that the economic program of a laissez-faire society must not only make provision for the current wants of the population, but must include a well-directed plan for building and expansion in order to afford the necessary channel for the direct savings of the people and the accumulated profits of businesses which together form the driving force for continued activity.

The Future of the C. P. A.

By Charles Weissinger

Schools, colleges and universities teaching business administration, accounting, finance and commerce every year are turning out thousands of young men who, with very little practice and experience, can do a good portion of the work that was formerly done by some of the certified public accountants. In the past four years, the number of certified public accountants has been growing far more rapidly than the demands of business required. Therefore, it now behooves the practising certified public accountants to look about for additional justifications for a continuation of their existence as public practitioners. Some of them will naturally be absorbed by industry in permanent positions. Others will want to remain in public work. To be enabled to do this, they must enlarge their scope and elevate their services to higher levels of achievement.

The following statements and suggestions are not inspired by any spirit of fault-finding but rather by an intense desire to see the profession as a whole finding beneficial paths to higher accomplishments.

A training that only emphasizes the technicalities of our work no longer forms a sufficient background for the professional accountant. There is a wide distinction between the *art* of bookkeeping, requiring specific mental and manual skills, and the *science* of accounting. The latter requires not only the bookkeeping skills and a thorough understanding of the principles and application of accounting problems in our modern businesses, but also a background of general and business education and experience leading to an understanding of our present economic system, its history, present status in this and other countries of the world and its probable future.

Such a background comes from the acquisition of a liberal, progressive education and broad culture, in the best sense of those terms, supplemented with varied experiences. The problems of modern business are so intricate that the accountant who does not possess the necessary education, culture and practice will be handicapped and will fail to realize the full opportunities of his profession.

Accountants now have greater responsibilities than they ever had before and these in time will become even more numerous. They must aid their clients in making their businesses efficient and profitable and they are also under an ethical and legal obligation to see that such work as is delegated to them is carried on within the restrictions and requirements of statute and economic laws. These are grave responsibilities, and those who follow this profession in the future will need a broad social outlook, ability and talents of a high order. Accountants must begin to enter more into the business of the nation, becoming economists and industrial engineers as well as auditors.

Of the foremost and best experienced accountants and educators, there were some who have held this idea for the past twenty-five years. For example, in April, 1910, a prominent Pennsylvania accountant, Herbert G. Stockwell, offered a report as chairman of a committee on education in which he called the attention of the profession to the greater opportunities that lie before them and to the need of up-to-the-minute education for certified public accountants.

One of the professors at the university of Pennsylvania, E. S. Mead, about twenty-seven years ago expressed similar ideas, but before any organized effort could be made to act upon these suggestions, the new tax work began to occupy the minds and attention of accountants and the ideas did not receive the attention which must now be given them.

A great many business men look upon the accountant as a sort of cynical, critical, finicky creature, who unconsciously restricts his realm to the doing of a high grade of police duty (auditing) and preparing statements from history more or less ancient. This existing condition is due largely to the fact that most accountants do not broaden out rapidly enough and allow the world to move away from them, intellectually speaking.

Production and profit engineers are making great inroads on work, part of which was formerly delegated to certified public accountants, and some of these engineers are not nearly so well equipped by training and education.

One of the great troubles with some accountants is that unless a thing appears in the trial balance or in the general ledger or on the statement of assets and liabilities or on the statement of manufacturing, trading and profit and loss, they reason that it is not within their province to pay attention to it. If ever, in the history of this generation, there was a time when these conditions were manifest, it is now. There is not a statement today, if it is taken from the books and the books have not yet been adjusted to present values, which tells the truth under these abnormal conditions. The net worth in many a case is merely 25 per cent. of what the books show. In businesses that have been in existence for a great many years, the actual worth of the company may be five times greater than is shown on the books. Present conditions should drive home the thought that the knowledge and activities of the world do not stop with the picture which the accountant paints in figures if he relies wholly upon the recorded history.

One publisher was heard to say to a young certified public accountant: "The accounting profession is doomed. You had a mushroom growth through the impetus which the income tax and excess-profits taxes gave you and you are suffering a mushroom death." Even if the speaker was only 25 per cent. right, that should be enough to make accountants sit up and take notice and find additional avenues of usefulness to take the place of the tax work which has gone from them. Those who realize their limitations in time will be able to rise above them. Societies of other men in kindred callings are taking this problem seriously and bringing it forcibly to the attention of their members.

Progressive accountants belong to the local and national organizations of office managers, cost accountants and industrial engineers in order to get a broader background of experience. The functions of these societies are intermingled, but they all work toward the same end—to fit their members to manage an engagement in which many phases of accounting and engineering are involved. The certified public accountant is a professional man and if he had been awake in the past to the opportunities that were his to take, he would have embraced all of the various schools of thought which are held by the other organizations just mentioned. He does embrace some of them, but he should possess all of them. They should be his and a part of him and his work. When the organizations of certified public accountants fail to provide these features for their members, they are not functioning as effectively as they should. It is not expected of any certified public accountant that he is going to be the best expert in all of those different avenues of action, but he should have a good working knowledge of all of them in order to direct the efforts of others who may be more skilled in the execution of the details.

The organization of industrial engineers has the following aims: "(1) To study how to reduce waste and how to increase efficiency, economy, and goodwill in industry and commerce; (2) to promote a more general understanding of the rights and interests of the public, investors, consumers, employees and executives; (3) to assist federal, state and local governments in securing efficiency and economy concerning public affairs and in improving governmental activities affecting the management of industry and commerce; (4) to further the effective coördination of the various functions of management; (5) to provide a medium through which engineers, accountants, managing executives, and others engaged in applying scientific methods to the solution of industrial problems can further the foregoing objects and promote their professional interests."

The society sponsors visits to industrial and financial plants in order that its members may have first-hand information about the actual problems of production, management and finance. Recently, some of its members in Philadelphia and vicinity, some of whom were certified public accountants, visited a plant manufacturing food products, one manufacturing luxuries and another turning out steel products.

Its meetings are divided into sections, the production management section, motion and time study section, office management section—usually one meeting a month under each section. At the meetings, topics pertinent to the section sponsoring the meeting are discussed.

At a recent meeting, the production management section used motion pictures, one on "Manufacturing of sheet steel by the continuous mill method" and one on "Latest processes for production of safety steel automobile bodies, and methods for testing the finished product in comparison with other types of construction." After the films were shown, the men discussed the subjects which were of interest to all.

The local chapter of the institute of certified public accountants could form similar sections and instead of meeting once a month, meet once a week and let those who are particularly interested in a given calling attend on the night when that subject is under debate and for their own advancement also attend the others.

The society of cost accountants goes into the technocracy of accounting: dictaphone, ditto, Ediphone, calculating machines, registers and other machinery used in accounting, and one of the policies is to hear all sides of a question. In their meetings, for example, the members might discuss the construction of the balance-sheet. They will have present a practising accountant and also an industrial executive who does not practise accounting. In one of the recent meetings, they had a Socratic discussion of cost and among those present were a practising accountant in public work, a practising accountant in private work associated with a manufacturing company international in scope, the owner of another manufacturing company and a professor from the university of Pennsylvania. It was surprising to find that each man approached the subject from a different viewpoint and that in each case the conclusions were different.

At a meeting which took place some time ago, the speaker's topic was "The reaction of foreign trade on Philadelphia prosperity." We need topics like that.

An outstanding member of the organization is conducting a series of lectures covering costing methods in practical installations. A meeting is held once a month for those who care to attend and the subjects are approached from the points of view of control, distribution and analysis. This man is doing this for the cost accountants' association and is one of the progressive, practising certified public accountants.

All of these features should receive the consideration of the profession. In proof of this, attention is called to the fact that many practising public accountants do actually avail themselves of these benefits and study the trends and changes. These, however, form a small percentage of the total membership.

The group of office managers undertakes to make surveys of plants and then prepares from the information a sort of symposium, the benefit of which is given to its members.

In the discussions of the managements of office, among other things, stress is laid upon the saving of time, money, energy, the standardizing of the flow of work, standardizing correspondence, bookkeeping and accounting methods, standardizing forms, filing methods, physical office conditions, personnel and many other problems which are constantly presenting themselves in the experience of the various members of that association.

At one of the conferences, the idea was stressed that the ultimate aim of any industry is not to make profits but to render service to society and that, in choosing the methods which were to be followed, managers should look ahead to the purpose actually desired rather than to any orthodox methods of getting there.

We, as certified public accountants, must examine ourselves. Are we too orthodox? Do we look into the future to see where our paths are leading? Contrary to the tradition, we should get off the straight and narrow path and branch out into divergent fields. We must realize that the ultimate aim of the profession also is to render service to society.

All matters of this kind tend to broaden the vision of the accountant and therefore increase his usefulness and enable him to practise as a certified public accountant, with greater benefit to his clients and more satisfaction to himself.

One difficulty that organizations like a society of certified public accountants have to cope with is the fact that they are dealing with professional men, licensed by the state to practise, whereas only a small percentage of the office managers, the cost accountants and the industrial engineers have reached that distinction. One thought to be kept in mind when considering ways and means of broadening the scope of the accountant's work is that these other men might be invited to take part in the certified public accountants' meetings. They might even be allowed to join the society and there could be several ways of denominating the different classes of membership. Colleges have their freshmen, sophomores, juniors and seniors; social clubs have their ranks and degrees; accountants could have various associate memberships in their chapters and state societies which would not be allowed the voting and office-holding privileges of the certified public accountants.

The preliminary education of young men preparing to enter the profession of the certified public accountant should include, in addition to the other things already mentioned, a strong foundation in political economy. Most men do not take enough interest in governmental procedures and results. Accountants should take an outstanding part in local, state and federal business, because they are finally the ones best fitted to interpret the results. It is the duty of every citizen, not only to make money in the present, but so to aid in formulating plans for the future that he shall pass on an even greater heritage than he has received. If certified public accountants do not realize that a share of these burdens should rest on their shoulders, they are not true to their responsibilities.

There should be an accountant taking a major part in every governmental system, but unless he is also a manager and an economist, he will not be fitted for such a position. However, being an economist, he should be better able to point the way for the nation to avoid the extremes of speculation and the depths of depression.

There are numerous possibilities open to the certified public accountant to justify a continuance of his existence, which he must recognize if the profession is to continue to make the progress in the next quarter of a century that has been made in the one just passed. Many opportunities will present themselves where good results can be obtained which will bring credit and profit to the certified public accountant and benefit to the world at large. To accomplish this, there should be a national body, like the American Institute of Accountants, that would undertake to weld the public accountants, industrial engineers, cost accountants, office managers and the like into one body of which the certified public accountant would be, if not the dominating factor as suggested herein, an important one. Great good would come from the powerful influence which such a unity would possess and such resourcefulness would redound to the benefit of the practitioner in public work.

It is the earnest wish of the professional men who see where the path is leading that the rest of the profession, particularly the younger men, analyze their potentialities, possibilities, positions and careers and decide before it is too late just what kind of a future they are going to work out for themselves.

Students' Department

H. P. Baumann, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

[Note.—The fact that these answers appear in The Journal of Accountancy should not cause the reader to assume that they are the official answers of the board of examiners. They represent merely the opinions of the editor of the *Students' Department.*]

Examination in Auditing

May 17, 1934, 9 A. M. to 12:30 P. M.

Answer the first nine questions and either of the last two.

No. 1 (10 points):

(a) What is a "hidden" or "secret" reserve?

(b) When intentionally created, what four reasons, valid or not, are usually advanced in justification?

(c) Should an auditor ever approve such reserves?

Answer:

(a) The understanding of the value of an asset or the overstating of the amount of a liability, or both, with a consequent understating of the amount of surplus or capital, results in creating a hidden or secret reserve.

(b) The following reasons are frequently advanced in an attempt to justify the creation of secret reserves:

1. Conservatism.
2. Equalization of profits (reserves created in good years may be used to improve the showing of poor years and thus maintain uniformity and stability).
3. Concealing excess profits tends to avert competition.
4. Excess profits create an undesirable expectation in the minds of the stockholders that such profits should continue.
5. Provisions against unforeseen contingencies.

(c) The auditor should not approve such reserves, for, obviously, the financial condition of the business is not reflected in a statement containing them. Stockholders are entitled to the facts, upon which they themselves may determine whether or not their investment is a satisfactory one. Further, the creation of a secret reserve would result in false returns for tax purposes if the statements were used, without adjustment, in the preparation of such returns.

No. 2 (10 points):

The American Institute of Accountants has suggested and the New York Stock Exchange has adopted the following form of report to be used instead of the ordinary "short certificate," viz.:

Accountants' Report

"To the XYZ Company:

"We have made an examination of the balance-sheet of the XYZ Company as at December 31, 1933, and of the statement of income and surplus for the year 1933. In connection therewith we examined or tested accounting records to the company and other supporting evidence and obtained information and explanations from officers and employees of the company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

"In our opinion, based upon such examination, the accompanying balance-sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the company during the year under review, its position at December 31, 1933, and the results of its operations for the year."

Compare the above form with the ordinary "short certificate," and state what advantages, in your opinion, it has over the latter.

Answer:

The advantages of the suggested form of certificate over the ordinary "short certificate" are:

1. It is addressed directly to the company, while the short certificate was not always addressed.
2. It plainly states the sources from which the information was obtained, and that it is not a detailed audit. These points are not always clearly set forth in the short certificate.
3. The phrase "in accordance with accepted principles consistently maintained by the company during the year under review" is probably the most important and desirable improvement made in the suggested form. If no exceptions are noted, it gives assurance that (1) the company's accounting methods are in keeping with accepted principles, and (2) that no change in policy during the year has distorted the showing of operating results and nullified a comparison of opening and closing balance-sheets.
4. A uniform certificate which is generally accepted is more desirable than the short certificates, no two of which are the same.

No. 3 (10 points):

You are employed by a small firm of retail dealers to close its books for the year and prepare a profit-and-loss statement and a balance-sheet. You are not expected to verify the accounts beyond making corrections of obvious errors, such as postings to wrong account and the like.

How should you protect yourself from having the firm use your statements for credit purposes as having been audited by you?

Answer:

The better protection may be obtained by preparing the statements on plain paper (without letterhead or firm name), so that the name of the accountant does not appear thereon in any form. However, if the accountant's name is to appear, a note to the effect that the statements have been prepared from the books without audit should be placed on the face of the statement; viz.:

Balance-sheet

December 31, 1933

(Prepared from the books of the company, without audit)

The first method is, by far, the better one.

No. 4 (10 points):

The total amount of the inventory of merchandise of a trading concern has been increasing each year for the last three years while the gross profits have been diminishing.

(a) State the probable reasons for this; and

(b) How you would proceed to discover the real cause.

Answer:

(a) The increases in the inventories and the diminution of the gross profits may be attributable to almost any combination of the factors listed under (A) and (B) below:

A. The inventory increase may be due to:
  1. An increase in the purchase cost, or
  2. An increase in quantities, due to
     (a) Adding new lines.
     (b) Excessive purchases (beyond actual requirements).
     (c) Heavy purchases in anticipation of rising prices.
     (d) Change in trade practice or policy, resulting in a shift of the burden of carrying inventory.
     (e) Accumulation of obsolete or unsalable items.
  3. Overstatement of value, through fraud or error. This factor is unlikely, as the gross profits have decreased.

B. The diminishing gross profits may be the result of:
  1. Decreasing sales, or
  2. A lower rate of gross profit, due to
     (a) Lower selling prices.
     (b) Higher purchase prices.
  3. Fraud.

(b) The real cause of the inventory increase could be determined by making analyses of the last three inventories, department for department, or, better still, item for item, to see (1) whether the unit costs were higher, (2) whether new items had been added, or (3) whether quantities were greater; if the last were the case, further investigation would be required to determine the reason therefor.

The operating statements would show whether the decline in gross profits was due to lower sales volume, or to a smaller margin of gross profit. If the latter proved to be the case, analysis of sales and purchase records should locate the cause.

The sales records should be checked against the shipping records to ascertain whether the goods shipped have been entered as sales. The purchase records should be checked against the receiving records to learn whether the goods represented by the purchase invoices were actually received.

Numerous likely combinations of the foregoing factors under A and B present themselves. For example:

1. The company may be adding new lines, and old merchandise may have accumulated which can be realized upon only slowly and at a loss (thus reducing the gross profit).
2. Purchases may be made in advance of the selling season, and the expected sales may not materialize, with the result that the inventories

will increase and the gross profit decrease on the sale of the merchandise thus accumulated.

3. Purchase prices may be rising, and it may be impossible to pass on the higher prices to the consumer.
4. Competition may be reducing the margin of profit while the increased volume requires greater stocks.

No. 5 (10 points):

If inventory declines in value between the date of statement and that of certification, and the concern audited has a potential loss on purchase commitments, what is the responsibility of the auditor to indicate the loss as of certification date?

Answer:

The auditor's statements should reflect all of the facts that he has discovered which have a bearing on the financial condition of the concern. From this standpoint, the matter of purchase commitments should be treated as follows:

Any prospective loss on purchase commitments at the balance-sheet date (measured by the difference between the contract price and the market price on that date) should be provided for by a reserve set aside from the surplus account.

Any substantial loss due to price declines between the balance-sheet date and the date of certification might be covered by a footnote appended to the balance-sheet, as follows:

If there is a reserve set aside:

"Based on the current market prices as of March 3, 1934, there is an additional potential loss of $50,000 on purchase commitments."

If there is no reserve:

"Purchase commitments in the amount of $400,000 were outstanding on December 31, 1933; on March 3, 1934, the market value of the materials to be received thereon was $350,000."

No. 6 (10 points):

You are engaged by the directors to make a balance-sheet audit of the X Bank at the close of 1933. You are expressly requested to refrain from seeking confirmation from depositors or borrowers owing to public nervousness caused by the recent failure of another bank in the town, the clients of the X Bank being mainly of the working class unfamiliar with auditing procedure.

At the closing hour on December 30, 1933, you appear at the bank and the head bookkeeper hands you the following:

Balance-sheet, December 30, 1933

Assets		*Liabilities*	
Cash on hand	$ 50,000	Notes payable	$ 25,000
Due from banks	80,000	Due to banks	5,000
Stocks and bonds	100,000	Deposits: demand	530,000
Mortgages owned	200,000	" savings fund	420,000
Loans and discounts	600,000	Capital stock	200,000
Accrued int. receiv'l	10,000	Surplus	100,000
Bank building	50,000	Undivided profits	21,000
Furn. and fixtures	10,000		
Real estate foreclosed	100,000		
Federal deposit ins.	1,000		
	$1,301,000		$1,301,000

State how you will proceed to verify the items on the above balance-sheet.

Answer:

The auditor should maintain control of all of the cash, cash items, and negotiable instruments until he has completed his audit of such items. To facilitate the inspection and count of such assets as stocks and bonds, mortgages owned, loans and discounts, etc., it would be well to prepare schedules from the books and records before commencing the audit of those assets.

Cash on hand:

All cash should be counted; bundles of bills and rolls of coin should be tested. All cash and clearing items, checks, money orders, etc., should be forwarded for clearing under the control of the auditor, and should be followed up to see that the proceeds have been credited to the account of the X Bank.

Due from banks:

Confirmations should be requested from all of the banks, together with statements of the X Bank account from the date of the last statement to January 3rd or 4th, so that all transit items may be accounted for. The statements should then be reconciled with the ledger accounts.

Stocks and bonds:

These should be counted and inspected and checked against the prepared schedule. This schedule should contain a complete description and classification, including the purchase date, maturity date, interest rate, interest dates, par value, cost, market value, dividend rates, dividend dates, etc. All stocks and registered bonds should be in the name of the X Bank; all coupon bonds should have the future coupons attached. The accrued interest should be computed. Any securities not on hand should be noted and verified by confirmation from the custodians.

Mortgages owned:

All mortgages should be inspected and checked against the prepared schedule; those out as collateral or on trust should be confirmed. All accompanying documents—bonds, title guarantee, fire insurance—should be examined. Local mortgages might be confirmed by inspection of the county recorder's files. Interest income should be traced through the cash records, and the accrued interest computed. Past due and defaulted mortgages should be gone over with a bank official, and a reserve for loss should be set up.

Loans and discounts:

All notes on hand should be examined for formality and negotiability; signatures and endorsements on larger items should be compared with signatures on record. Notes discounted, or out for collection, should be confirmed. All collateral indicated by the register should be located, examined, and evaluated. Demand loans long outstanding, and past due time loans should be examined to determine whether a reserve for loss is required. Amounts due from officers and directors should be shown separately.

Accrued interest receivable:

The computation should be verified; no interest should be accrued on obligations in default.

Bank building:

Furniture and fixtures:

The ownership and the basis on which the accounts are carried—cost, depreciated cost, appraisal, arbitrary—should be ascertained and verified. An analysis of the accounts should be prepared.

Real estate foreclosed:

All supporting documents should be examined and checked against the prepared schedule. In the case of local real estate, title records should be examined. Receipts for the payment of taxes should be on hand. The basis of valuation (presumably face of mortgage and incidental costs of foreclosure) should be determined, and, if possible, the carrying value should be compared with the market value.

Federal deposit insurance:

This payment should be evidenced by a receipt and cancelled check, and confirmed by the Federal Deposit Insurance Corporation.

Notes payable:

Due to banks:

These items should be confirmed; the latter should be reconciled with the ledger for any items in transit.

Deposits: demand:

Deposits: savings fund:

Trial balances (adding machine tapes) should be prepared; any public funds or bank deposits included should be noted and confirmed. All overdrafts should be listed and set out on the audited statement. The regular end-of-the-month statements on the checking accounts should be sent out under the supervision of the auditor, and any differences reported by customers during the period of the examination should be checked by him.

A complete test of a recent interest distribution to savings accounts should be made to guard against the removal of depositors' accounts.

Capital stock:

A trial balance of the stockholders' ledger should be prepared and compared with the stock certificate books. If there is an outside registrar and transfer agent, a confirmation of the amount of stock outstanding should be obtained.

Surplus:

Undivided profits:

These accounts should be analyzed, and all entries made therein since the last closing should be examined.

Note—The total of the assets is $100,000 short.

No. 7 (10 points):

In preparing the income-tax return for a state bank you find it has been compelled by the state banking department to write down its stocks and bonds owned to market values as of March 31, 1933, an average reduction of 70%, resulting in showing a heavy book loss. Otherwise the bank's operations for the year would show a small profit. To avoid the federal tax the bank wishes to include the heavy mark-downs as a deduction in its return.

What would you advise, and why?

Answer:

Unrealized losses due to market fluctuations in the value of securities are not deductible for federal income tax purposes, even though ordered by the banking department. The following ruling has been issued on this point (I.T. 1221, C.B. June, 1922, p. 155):

> "The amount of depreciation on bonds which banks are required to write off by order of a state bank commissioner is deductible only where the shrinkage is due to the fact that the debtor corporation will not be able to pay the full amount of its obligation at maturity. Such shrinkage is not deductible in any other instance."

Any stocks or bonds which were entirely worthless, or any bonds in default on which sufficient information was available to permit the determination of partial worthlessness, should be written off, or written down to estimated value. The resulting loss is an allowable deduction.

Also, any stocks or bonds which the bank had acquired for resale might be inventoried for tax purposes at the lower of cost or market at the close of the year; banks are accorded the same privilege in this respect as are security dealers. (43 F. (2d) 950, 9 Am. Fed. Tax Rep. 207.)

Unless the exceptions noted in the two preceding paragraphs applied, the bank in question would be unable to make any deduction on its income tax return for decline in market values of securities owned.

No. 8 (10 points):

What general procedure should be followed in arriving at a fair valuation of—

(a) Plant account.
(b) Investments.
(c) Patents.
(d) Sinking fund to retire bonds?

Answer:

(a) Plant account should be valued at cost less adequate provisions for depreciation. Additions, disposals, and the adequacy of depreciation provisions should be checked. Repairs and maintenance accounts should be examined to determine that no capital expenditures had been charged to expense. Capital assets not in use, held for investment purposes, should be segregated from the plant account; assets discarded as worthless should be written off.

(b) Investments of temporary funds should be valued at the lower of cost or market. Permanent investments should be carried at cost, unless a substantial reduction in value occurs, in which case a reserve should be created out of surplus. Premium or discount on permanent bond investments should be amortized to maturity. Investments in subsidiary companies should be adjusted to give effect to the parent company's share of the profits, losses, and dividends of the subsidiary.

(c) Patents should be valued at cost less amortization. Cost might include development costs, payments to the inventor, and attorney and registration fees. Patents rendered valueless by later patents, or those not used for any other reason, should be written off to surplus. Those acquired for stock should be set up at their fair market value, if such value can be determined.

(d) Any cash in the fund should be shown as sinking fund cash. Securities purchased from sinking fund cash and held in the sinking fund should be carried at cost, and the premium or discount should be amortized over the life of such securities. If the company's own bonds are purchased for the sinking fund, and if these bonds are to be held alive until maturity, they should be treated as bonds of other companies, viz.: carried at cost, with the premium or discount amortized. If the company's own bonds are purchased and cancelled, the difference between par and the purchase price should be written off to surplus, along with any unamortized discount or premium on the issuance of these retired bonds. Accrued interest collectible should be computed and shown. The market value of those bonds carried at cost should be indicated, parenthetically, on the face of the balance-sheet.

No. 9 (10 points):

After a stormy stockholders' meeting and quarrels among the directors, you are engaged by the officers of a corporation to make a balance-sheet audit, the first in the corporation's existence of several years. You find the financial records in order and are ready to certify the balance-sheet, but the officers refuse to produce the minute-book for your inspection, offering instead to furnish you with attested copies of such resolutions as you deem necessary to verify certain items.

What will be your attitude in the matter? State your reasons fully.

Answer:

As the examination of the minute books is essential to the audit, the auditor should refuse to issue an unqualified certificate unless he is allowed access to them.

Attested copies of such resolutions as he may request will not suffice; the resolutions of which he has no knowledge may be of more importance. Particularly so, inasmuch as he is on notice of the dissension between the stockholders and directors.

The auditor should explain to the officers (and possibly the directors), that it will be necessary for him to qualify his certificate by plainly stating that he was denied access to the minute books.

No. 10 (10 points):

What is the proper handling of merchandise on consignment in a financial statement prepared for the consignor?

Answer:

Merchandise out on consignment and unsold at the balance-sheet date should be valued at the lower of cost (including freight to the consignee) or market and should be shown as "Merchandise on consignment." Any advances received from the consignee should be shown as a liability.

No. 11 (10 points):

You are asked by a client to undertake the recovery of an over-payment of federal income-tax which was due to alleged errors in the return. As an inducement he offers to give you half the amount recovered as your fee. What would be your reply? Give your reasons.

Answer:

This question was discussed editorially in the July, 1934, issue of The Journal of Accountancy, pages 3 to 5; the suggested answer contained in that discussion is directed to your attention. The following briefer answer is also submitted:

The client should be advised that the recovery of tax could not be undertaken on a contingent basis, because:

(1) By virtually placing himself in the position of sharing in the profits, the auditor makes it impossible for himself to maintain the unbiased attitude required of the professional man. Further, the auditor may even try so hard to remain unbiased that as a result he will lean backward, at his client's expense.

(2) If the case comes to trial and the auditor in the course of his testimony is questioned as to his compensation, the fact that his fee is contingent may have a damaging effect.

(3) The code of ethics of the American Institute of Accountants forbids the acceptance of engagements on a contingent fee basis.

(4) After ascertaining the grounds for the claim, the auditor should be able to weigh the chances and amount of recovery against the expenses involved; if he believes that the claim should be pressed, he should obtain his regular fee for his services, since they do not differ essentially from audit work. If the client desired a balance-sheet audit for credit purposes, he could hardly expect the auditor's fee to be contingent on obtaining the loan, and on the amount of the loan involved; the situation is essentially the same.

Ohio C. P. A. Examination

The following problem was set by the Ohio state board of accountancy in the May, 1933 examinations:

Problem No. 2:

Because of trade conditions, The Attractive Package Food Corporation marketed its product at selling prices reduced every four months during the fiscal year ended March 31, 1933. Likewise, raw materials were purchased on a declining market. Believing prices to have been stabilized and to have reached a permanent level in the last four months of the fiscal year, the board of directors authorized readjustments that would probably improve the position of the company.

The following trial balance at March 31, 1933, was submitted by the chief accounting officer:

Cash on hand	$ 2,000
Accounts receivable—trade	48,000
Notes receivable	3,000
Accrued interest receivable	60
Inventories, April 1, 1932	65,440
Returnable containers	2,120
Prepaid expenses	1,200
Land	40,000
Factory buildings	200,000
Machinery and equipment	300,000
Delivery equipment—trucks	4,500
Office equipment	10,000
Purchases	340,000
Direct labor	174,150
Manufacturing expenses	170,980
Depreciation—factory buildings	8,000

Depreciation—machinery and equipment	$ 30,000
Selling and administrative expenses	14,650
Other income and expenses, net	1,190
	$1,415,290

Surplus	$ 20,330
Notes receivable discounted	2,000
Reserve for bad debts	10,000
Reserve for depreciation:	
Buildings—7 years @ 4%	56,000
Machinery and equipment—7 years @ 10%	210,000
Delivery equipment—2 years @ 25%	2,250
Office equipment—7 years @ 8%	5,600
Bank loans	23,850
Accounts payable—trade	22,000
Notes payable—trade	14,000
Accrued expenses payable	760
Convertible 6% bonds—par $100,000	95,000
Sales	728,500
Common stock—2,250 shares, par $100	225,000
	$1,415,290

During the past year, labor rates were not changed, but effective April 1, 1933, a wage scale reduction of 16⅔ per cent. was announced. This will affect direct labor only. Manufacturing expenses will be reduced 20 per cent. during the coming year. Selling and administrative expenses and non-operating items are expected to remain constant.

The following results of an appraisal completed April 1, 1933, by a reputable appraisal company were to be entered on the books:

Classification	Replacement Cost new
Land	$ 35,000
Factory buildings	100,000
Machinery and equipment	159,510
Delivery equipment (trucks)	4,500
Office equipment	10,000
	$309,010

The appraisers reported the depreciation rates in effect are adequate and therefore will not be changed.

Upon investigation it was found that the cash consisted of items presented below:

New National Bank	$ 500
Old National Bank—impounded deposits	1,000
Cash on hand	500
	$ 2,000

The trade accounts receivable included charges to customers for the cost of returnable containers, amounting to $10,000, the returnable container account having been credited when the charges were made.

The 6 per cent. convertible bonds were issued at 90, half of the discount having been amortized at March 31, 1933, the date on which conversion was made. According to the terms of the agreement, the bonds were convertible at par for preferred stock at 105. One share of stock was issued for each $100 bond, the difference being settled by cash. Disregard bond interest.

The outstanding par common stock was exchanged 1 share for 1⅓ shares of no par common having a stated value of $75,000.

An analysis of the accounts for the year ended March 31, 1933, developed the following information:

Raw material inventories:

April 1, 1932	30,000 units @ $.80	$24,000
March 31, 1933	50,000 units @ .40	20,000

Work in process inventories:

April 1, 1932—One-third processed:				
12,000 units	—Material	@ $ .80		$ 9,600
	Labor	@ .10	($\frac{1}{3}$ of unit labor cost)	1,200
	Overhead	@ .12	($\frac{1}{3}$ of unit overhead cost)	1,440
				$12,240
March 31, 1933—One-half processed:				
15,000 units	—Material	@ $ .40		$ 6,000
	Labor	@ .15	($\frac{1}{2}$ of unit labor cost)	2,250
	Overhead	@ .18	($\frac{1}{2}$ of unit overhead cost)	2,700
				$10,950

Finished goods inventories:

April 1, 1932—			
20,000 units	—Material	@ $ .80	$16,000
	Labor	@ .30	6,000
	Overhead	@ .36	7,200
		$1.46	$29,200
March 31, 1933—			
16,000 units	—Material	@ $ .40	$ 6,400
	Labor	@ .30	4,800
	Overhead	@ .36	5,760
		$1.06	$16,960

Manufacturing cost:

Year ended March 31, 1933, 577,000 units @ $1.262426		$728,420
Sales—581,000 units, $728,500:		
April 1 to July 31, 1932	190,000 units @ $1.50	$285,000
August 1 to November 30, 1932	210,000 units @ 1.25	262,500
December 1, 1932, to Mar. 31, 1933	181,000 units @ 1.00	181,000
	581,000	$728,500
Purchases—600,000 units, $340,000:		
April 1 to July 31, 1932	200,000 units @ $.70	$140,000
August 1 to November 30, 1932	200,000 units @ .60	120,000
December 1, 1932, to Mar. 31, 1933	200,000 units @ .40	80,000
	600,000	$340,000

You were requested by the management to—

(a) Revalue the beginning and ending inventories for statement purposes, reflecting the new cost level resulting from the readjustments outlined.

(b) Prepare statement of profit and loss and manufacturing statement to reflect the possible result of operations during the coming year, assuming current prices to have reached a permanent level and the unit volume of sales remains the same. Disregard income tax.

(c) Prepare balance-sheet giving full effect to revaluation of assets, exchange of stock, conversion of bonds and other changes you may deem advisable from the information given.

Solution:

Requirements (a) and (b) of the problem are somewhat vague. Take the very first phrase, for instance, "Revalue the beginning and ending inventories for statement purposes": there is no basis whatsoever for revaluing the beginning inventories in the profit-and-loss statement for the year just ended, as the new cost level in effect April 1, 1933, can not influence the valuation of the April 1, 1932, inventory.

It thus appears that the "revaluation for statement purposes" refers to the estimated statements called for in (b), and that the latter are to be prepared by recasting the actual statements for the past year to give effect to the changed conditions.

The manufacturing statement required in (b) can not possibly be prepared in proper form, as no data is given as to estimated purchases and closing inventories; and the coming year's cost of sales can be determined without a manufacturing statement, merely by multiplying the number of units sold by the unit cost. Since a manufacturing statement is called for, it is prepared by restating the past year's statement as it would have appeared had the costs as of April 1, 1933, been in effect all year. The statement prepared in this manner does not pretend to correspond in detail to the actual statement that will be prepared at the end of the coming year, because of the differences—known and unknown—in the inventories. However, since total units are assumed to remain constant, and since the new unit costs are used in the adjusted statement, the total cost of sales shown by this statement is the expected cost for the coming year.

As the first step in the solution, the stated unit labor and overhead costs of $.30 and $.36, respectively, are verified:

Of the 577,000 units manufactured during the year,	
12,000 units were 1/3 processed on April 1, 1932, and the work done in completing them was equivalent to the manufacture of 2/3 of 12,000 or	8,000 units
The other 565,000 units were completely manufactured during the year	565,000 "
At the close of the year there were 15,000 units 1/2 processed, or the equivalent of	7,500 "
Therefore, the year's expenditures may be said to have produced	580,500 units

The unit labor cost is $174,150 ÷ 580,500, or $.30.

The total overhead is $208,980.00:

Manufacturing expenses	$170,980
Depreciation—factory buildings	8,000
Depreciation—machinery and equipment	30,000
Total	$208,980

The unit overhead cost is $208,980 ÷ 580,500, or $.36.

The manufacturing statement for the year just ended is next prepared, in such a way as to show the material, labor, and overhead elements of the cost of goods sold, and the units. The amounts for the adjusted statement are then determined, as follows:

Materials: at $.40 per unit, according to the number of units.
Labor: amounts for the past year are reduced 16⅔%.
Overhead: amounts for the past year are reduced 25%; this per cent. is computed below:

		Adjusted	
	Actual	Basis	Amount
Manufacturing expenses	$170,980	20% reduction	$136,784
Depreciation:			
Factory buildings	8,000	4% of $100,000 appraised value	4,000
Machinery and equipment	30,000	10% of $159,510 appraised value	15,951
Total	$208,980		$156,735

Reduction: $208,980—$156,735=$52,245, or 25%.
(See following page.)

The unit cost for the coming year is $.92; the closing inventory of finished goods cost $1.06 per unit. Since the unit selling price has been $1.00 since December 1, 1932, and since this price will remain constant, the finished goods may not be carried in the balance-sheet at $1.06 per unit; to permit a fair profit at the time of sale, the inventory is written down to the new cost of $.92. Likewise, the work in process inventory is costed on the new basis. To show these writedowns as a separate item in the statement of profit and loss, the closing inventories have been entered at cost in the manufacturing statement.

The amount of the writedown is computed as follows:

Finished goods inventory, March 31, 1933:			
Actual cost: 16,000 units at $1.06		$16,960	
At next year's costs: 16,000 units at $.92		14,720	
Excess			$2,240
Work in process inventory, March 31, 1933 (half processed):			
Actual cost to date, 15,000 units		$10,950	
Cost on new basis:			
Materials—15,000 x $.40	$6,000		
Labor—15,000 x ½ of $.25	1,875		
Overhead—15,000 x ½ of $.27	2,025	9,900	
Excess			1,050
Total writedown			$3,290

The statement of profit and loss for the year ended March 31, 1933, and the estimated statement for the coming year—the latter fulfilling the requirements of (b)—may now be prepared.

THE ATTRACTIVE PACKAGE FOOD CORPORATION
Statement of cost of goods manufactured and sold for the year ended March 31, 1933
Actual, and adjusted to reflect conditions effective on April 1, 1933

	Actual				Adjusted				
	Materials	Direct labor	Overhead	Total	Units	Materials	Direct labor	Overhead	Total
Work in process—April 1, 1932	$ 9,600	$ 1,200	$ 1,440	$12,240	12,000	$ 4,800	$ 1,000	$ 1,080	$ 6,880
Materials used, costs, and expenditures	344,000	174,150	208,980	727,130	580,000	232,000	145,125	156,735	533,860
Totals	$353,600	$175,350	$210,420	$739,370	592,000	$236,800	$146,125	$157,815	$540,740
Deduct: work in process, March 31, 1933	6,000	2,250	2,700	10,950*	15,000	6,000	1,875	2,025	9,900
Cost of goods manufactured	$347,600	$173,100	$207,720	$728,420	577,000	$230,800	$144,250	$155,790	$530,840
Finished goods, April 1, 1932	16,000	6,000	7,200	29,200	20,000	8,000	5,000	5,400	18,400
Totals	$363,600	$179,100	$214,920	$757,620	597,000	$238,800	$149,250	$161,190	$549,240
Finished goods, March 31, 1933	6,400	4,800	5,760	16,960*	16,000	6,400	4,000	4,320	14,720
Cost of goods sold	$357,200	$174,300	$209,160	$740,660	581,000	$232,400	145,250	$156,870	$534,520
Unit costs	$.615	$.30	$.36	$1.275		$.40	$.25	$.27	$.92

* At actual cost; writedown to replacement cost reflected in profit-and-loss statement.

THE ATTRACTIVE PACKAGE FOOD CORPORATION

Statement of profit and loss for the year ended March 31, 1933, and estimated statement for the coming year

	Year ended March 31, 1933	Estimate for coming year
Sales	$728,500	$581,000
Cost of sales	740,660	534,520
Gross profit (loss*) on sales	$ 12,160*	$ 46,480
Writedown of closing inventory	3,290	
Adjusted gross profit (loss*)	$ 15,450*	$ 46,480
Selling and administrative expenses	14,650	14,650
Profit (loss*) on operations	$ 30,100*	$ 31,830
Other income and expenses—net	1,190	1,190
Net profit (loss*) before income taxes	$ 31,290*	$ 30,640

The working papers and balance-sheet follows:

Explanatory adjustments to working papers

(1)

Surplus—appraisal	$245,490	
Land		$ 5,000
Factory buildings		100,000
Machinery and equipment		140,490

To record the replacement cost, new, of the following fixed assets, per the appraisal of the Appraisal Company as at April 1, 1933.

Asset	Cost	Appraisal	Excess
Land	$ 40,000	$ 35,000	$ 5,000
Buildings	200,000	100,000	100,000
Machinery & equipment	300,000	159,510	140,490
Totals	$540,000	$294,510	$245,490

(2)

Reserve for depreciation:		
Factory buildings	28,000	
Machinery and equipment	98,343	
Surplus—appraisal		126,343

To adjust the accrued depreciation:

Asset	Per Cent depreciated	Excess of cost over appraisal	Excess depreciation
Buildings	28%	$100,000	$ 28,000
Machinery & equipment	70%	140,490	98,343
Total			$126,343

(3)

Old National Bank—impounded deposits	$ 1,000	
Cash on deposit		$ 1,000
To segregate the deposits in the Old National Bank.		

(4)

Returnable containers in hands of customers	10,000	
Accounts receivable		10,000
To transfer the cost of the returnable containers in the hands of customers.		

(5)

Surplus	5,000	
Convertible 6% bonds		5,000
To write off the unamortized discount on the convertible 6% bonds converted on March 31, 1933.		

(6)

Convertible 6% bonds	100,000	
Due from bondholders	5,000	
Preferred stock		100,000
Premium on preferred stock		5,000
To record the conversion of bonds for preferred stock as at March 31, 1933.		

NOTE.—The problem states that the bonds were convertible at par for preferred stock at 105; and that one share of stock was issued for each $100 bond, the difference being settled by cash. If the cash had been received, to what account was it credited? As no such credit is apparent on the books, the amount must be shown as a receivable from the bondholders. It is necessarily assumed that the face value of the bonds is $100,000, and that the stock is $100 par.

(7)

Common stock—par value $100 per share	$225,000	
Common stock—no par value		$ 75,000
Paid-in surplus		150,000
To record the exchange of 3,000 shares of no par value common stock of a stated value of $75,000 for 2,250 shares of the old $100 par value stock.		

(8)

Inventory writedown	3,290	
Reserve to reduce inventory to replacement cost		3,290
Writedown of labor and overhead element in closing inventories to new basis. (Closing inventories were entered at cost in the working papers to permit showing the writedown as a separate item.)		

(See pages 306 and 307)

THE ATTRACTIVE PACKAGE FOOD CORPORATION
Balance-sheet, March 31, 1933

Assets

Current assets:				
Cash			$ 1,000	
Due from bondholders			5,000	
Accounts receivable		$38,000		
Less: reserve for bad debts		10,000	28,000	
Notes receivable		$ 3,000		
Less: notes receivable discounted		2,000	1,000	
Accrued interest receivable			60	
Inventories:				
Raw materials		$20,000		
Work in process		9,900		
Finished goods		14,720	44,620	$ 79,680
Returnable containers:				
On hand			$ 2,120	
In hands of customers			10,000	12,120
Impounded bank deposit—Old National Bank				1,000
Prepaid expenses				1,200
Fixed assets (as appraised March 31, 1933):				
	Replacement cost new	Reserve for depreciation	Present value	
Land	$ 35,000		$ 35,000	
Factory buildings	100,000	$ 28,000	72,000	
Machinery and equipment	159,510	111,657	47,853	
Office equipment	10,000	5,600	4,400	
Delivery equipment	4,500	2,250	2,250	
Total	$309,010	$147,507		161,503
				$255,503

Liabilities and net worth

Current liabilities:				
Bank loans			$ 23,850	
Accounts payable—trade			22,000	
Notes payable—trade			14,000	
Accrued expenses payable			760	$ 60,610
Net worth:				
Preferred stock, $100 par value			$100,000	
Common stock, 3,000 shares of no par value; stated value			75,000	
Surplus (deficit*):				
Paid-in:				
Created by transfer from common stock	$150,000			
Premium on preferred stock	5,000			
Total		$155,000		
Appraisal—writedown of fixed assets		119,147*		
Earned:				
Balance, April 1, 1932	$20,330			
Less: loss for the year	$31,290			
Unamortized discount on bonds converted	5,000			
Total	$36,290			
Balance, March 31, 1933		15,960*		
Net surplus			19,893	194,893
				$255,503

THE ATTRACTIVE PACKAGE FOOD CORPORATION
Working papers, March 31, 1933

	Trial balance March 31, 1933		Adjustments		Profit and loss		Balance-sheet	
			Debit	Credit	Debit	Credit		
Cash on deposit	$ 2,000			(3) $ 1,000			$ 1,000	
Accounts receivable—trade	48,000			(4) 10,000			38,000	
Notes receivable	3,000						3,000	
Accrued interest receivable	60						60	
Inventories, April 1, 1932	65,440				$ 65,440	$ 47,910	47,910	
Returnable containers	2,120						2,120	
Prepaid expenses	1,200						1,200	
Land	40,000			(1) 5,000			35,000	
Factory buildings	200,000			(1) 100,000			100,000	
Machinery and equipment	300,000			(1) 140,490			159,510	
Delivery equipment—trucks	4,500						4,500	
Office equipment	10,000						10,000	
Purchases	340,000				340,000			
Direct labor	174,150				174,150			
Manufacturing expenses	170,980				170,980			
Depreciation—factory buildings	8,000				8,000			
Depreciation—machinery and equipment	30,000				30,000			
Selling and administrative expenses	14,650				14,650			
Other income and expenses—net	1,190				1,190			
Surplus		$ 20,330	(5) $ 5,000					$ 15,330
Notes receivable discounted		2,000						2,000
Reserve for bad debts		10,000						10,000
Reserve for depreciation:								
Buildings—7 yrs. at 4%		56,000	(2) 28,000					28,000
Machinery and equipment—7 yrs. at 10%		210,000	(2) 98,343					111,657
Delivery equipment—2 yrs. at 25%		2,250						2,250
Office equipment—7 yrs. at 8%		5,600						5,600

Bank loans		$ 23,850						$ 23,850
Accounts payable—trade		22,000						22,000
Notes payable—trade		14,000						14,000
Accrued expenses payable		760						760
Convertible 6% bonds—par $100,000		95,000	(6) $100,000	(5) $ 5,000				
Sales		728,500				$728,500		
Common stock—2,250 shares par $100		225,000	(7) 225,000					
Totals	$1,415,290	$1,415,290						
Surplus—appraisal			(1) 245,490	(2) 126,343			$119,147	
Old National Bank—impounded deposits			(3) 1,000				1,000	
Returnable containers in hands of customers			(4) 10,000				10,000	
Due from bondholders			(6) 5,000				5,000	
Preferred stock				(6) 100,000				100,000
Premium on preferred stock				(6) 5,000				5,000
Common stock—no par value				(7) 75,000				75,000
Paid in surplus				(7) 150,000				150,000
Inventory writedown			(8) 3,290		$ 3,290			
Reserve to reduce inventory to replacement cost				(8) 3,290				3,290
Net loss						31,290	31,290	
			$721,123	$721,123	$807,700	$807,700	$568,737	$568,737

Institute Examination in Law

By Spencer Gordon

The following answers to the questions set by the board of examiners of the American Institute of Accountants at the examination of May, 1934, have been prepared at the request of The Journal of Accountancy. The answers have not been reviewed by the board of examiners and are in no way official. They represent merely the personal opinions of the author.—*Editor*, The Journal of Accountancy.

Examination in Commercial Law

May 18, 1934, 9 A. M. to 12:30 P. M.

Reasons must be stated for each answer. Whenever practicable, give the answer first and then state reasons. Answers will be graded according to the applicant's evident knowledge of the legal principles involved in the question, rather than on his conclusions.

Group I

Answer all questions in this group.

No. 1 (10 points):

Williams, a patent lawyer, was rendering legal services to Young on applications for patents which Young had made. Prior to the issue of the patents, Young made a contract with Bostwick whereby Bostwick agreed to conduct and pay for further prosecution of the applications. In this contract no mention was made of Williams or of any other patent lawyer. Williams knew that the contract was made and in reliance upon it he thereafter rendered legal services in the further prosecution of the applications but without the knowledge or consent of Bostwick or Young. Williams sued Bostwick on the theory that Williams was a third party beneficiary under the contract. For whom should judgment be rendered?

Answer:

Judgment should be rendered for Bostwick. The parties intended that the contract should protect Young. There is nothing in it which would show an intention to confer a benefit on a third party beneficiary. The fact that the carrying out of the contract required engaging a patent attorney is not determining because none of the provisions of this contract was intended to benefit Williams. To allow a party to recover on a contract to which he is not a party, it is necessary that the contract shall not merely operate for his benefit, but that it shall have been intended for his benefit.

No. 2 (10 points):

A savings bank received a letter purporting to be signed by one of its depositors and enclosing that depositor's pass-book. The letter contained a request that a cheque for part of the balance of the account be mailed to him at an address in another state. The bank as requested mailed the cheque and the pass-book, enclosing them with a letter addressed to the depositor. The cheque was presented to the drawee national bank by the writer of the first letter, and he identified himself by showing the depositor's pass-book and the letter written by the savings bank. The national bank paid the cheque. Subsequently the savings bank learned that its depositor's pass-book had been stolen and that the letter purporting to be from him was a forgery. Can the savings bank recover the amount of the cheque from the national bank?

Answer:

The savings bank can recover the amount of the cheque from the national bank, the drawee. Where the payee's endorsement upon a cheque is forged and the drawee bank pays the cheque, the general rule is that the loss falls upon the drawee bank. If the drawer has been negligent so that the drawee is imposed upon, then the drawer must bear the loss. However, even if it is assumed that the drawer was negligent, such negligence is immaterial where, as here, the drawee pays the cheque without sufficient identification of the payee and upon a forged endorsement of the payee's signature.

No. 3 (10 points):

Each of the following paragraphs purports to summarize the law on the point involved. State as to each of them whether or not it is correct; if any one is incorrect restate it; and in each instance give the legal reasons on which the rule is based:

(a) A stockholder has a preëmptive right to participate ratably with other stockholders in subscribing for new shares when the corporation's capital stock is increased and new stock is issued.

(b) A stockholder has the same right with respect to authorized but unissued stock.

(c) A stockholder has the same right with respect to treasury stock acquired by the corporation with the intention of reissuing it.

(d) A stockholder has the same right with respect to treasury stock, acquired by the corporation with the intention of retiring it, which later is offered to investors.

Answer:

(a) This statement is correct in most jurisdictions. The principle of law is that taking away the preëmptive right would lessen the stockholder's proportionate voice in the control of the corporation and his proportionate share in the surplus of the corporation without his consent.

(b) This statement is incorrect in most jurisdictions because the stockholder takes his stock with knowledge that there is other stock unissued.

(c) This statement is incorrect. The stockholder's proportionate share is not affected by such a transaction.

(d) This statement is correct, although the law is not clear-cut on this subject. It is stated that such stock may cease to be true treasury stock within the rule permitting reissue without affording stockholders a right to participate ratably. The same theory of law is responsible for this statement, i. e., a supposedly permanent proportionate voting status is disadvantageously affected. It would seem to be a factual question as to whether the stock is or is not treasury stock at time of sale.

No. 4 (10 points):

Plaintiff entrusted securities to defendant, a stockbroker, for safe-keeping. Plaintiff was not dealing on margin and he was not indebted to defendant in any amount, and defendant charged plaintiff a reasonable fee for his custodianship. Plaintiff gave defendant no authority to hypothecate these securities, but defendant nevertheless pledged them as security for a loan. Defendant became bankrupt and the pledgee of the securities legally and in due form sold them. Plaintiff now sues defendant for the value of the securities and de-

fendant pleads his discharge in bankruptcy as a defense. Discuss the validity of this defense on each of the following assumptions:
(a) Defendant hypothecated the securities wilfully and maliciously;
(b) Defendant hypothecated them through an innocent but mistaken belief that the securities belonged to defendant.

Answer:

(a) If defendant hypothecated the securities wilfully and maliciously, a discharge in bankruptcy would not bar the action.

(b) If defendant hypothecated the securities innocently under mistaken belief of ownership, a discharge in bankruptcy would be a valid defense. The act must be wilful or malicious to prevent the bankrupt broker from setting up his discharge in bar in a conversion action.

No. 5 (10 points):

Stern, by a written instrument, legally guaranteed the payment by Colt of all charges for goods purchased from the Emporia Company. Colt failed to pay certain proper charges and the Emporia Company sued Colt. During the trial, the case was settled and discontinued upon Colt's written agreement to pay a stated amount in specific instalments, with the proviso that the entire balance of the stated amount would become due upon default in the payment of any instalment. Thereafter Colt defaulted in his second instalment. Is Stern liable on his guarantee?

Answer:

Stern is not liable on his guarantee. The new agreement gave Colt additional time to pay and any such change in an obligation or duty of principal without guarantor's consent discharges guarantor of obligation.

Group II

Answer any five questions in this group. No credit will be given for additional answers, and if any are submitted only the first five will be considered.

No. 6 (10 points):

Jordan was a salesman on commission with a drawing account. In March, 1932, he was discharged and a dispute arose between him and his employer as to the amount due him. On April 7, 1932, the employer gave Jordan a cheque for $390, marked "Final" on its face and endorsed "Payment in full for commissions earned or to be earned and/or all claims to date." Jordan added to this "Also subject to Mr. Jordan's letter of 4/7/32," endorsed the cheque and cashed it. In his letter of April 7, 1932, Jordan wrote his employer that he was "compelled to receive this cheque under protest subject to adjustment of my account." Did Jordan's acceptance of this cheque constitute an accord and satisfaction?

Answer:

Jordan's acceptance of this cheque amounted to an accord and satisfaction. He could not use the cheque and then seek to disregard the condition on which it was tendered. He accepted the cheque on the express condition that it was in satisfaction of a bona-fide controversy then existing between the parties.

No. 7 (10 points):

The president of a corporation had power under the by-laws to appoint, to remove and to fix the compensation of employees. Without express authorization from or ratification by the board of directors he made a contract with Jones whereby the corporation was to employ Jones for life. Was this contract binding upon the corporation?

Answer:

This contract was not binding on the corporation. If authorized by the corporation it would be sustained, but the president of a corporation as such has no authority to make a contract with anyone for a lifetime employment even under the general power stated. The power to make such an unusual contract can not be implied and since it can not be found to be given expressly the contract was beyond the president's power and is therefore not binding on the corporation.

No. 8 (10 points):

The X Dress Corporation made a promissory note payable to the order of "ourselves." Brown was president of that corporation and as such he signed the note. The note was endorsed before maturity by the maker corporation and by Brown individually. Prior to the due date of the note, the X Dress Corporation made an assignment of its assets for the benefit of creditors and said assignment was executed by Brown as president. The note was not paid at maturity and the maker corporation and Brown individually were sued. Notice of dishonor of the note had not been given to Brown. Can Brown be held as endorser?

Answer:

Brown can not be held as an endorser. To hold an endorser liable upon a promissory note, notice of the failure of the maker to pay the note must be given the endorser. The notice must be to the effect that the endorser is looked to personally for payment. Even if Brown, in his capacity as president of the corporation which made the note, knew that it would not be or had not been paid, such knowledge does not dispense with the necessity of giving notice of nonpayment to him personally as endorser. Nor does the financial condition of the corporation maker, resulting in an assignment for the benefit of creditors which was executed by Brown as president, dispense with the requirement that he be given notice of nonpayment.

No. 9 (10 points):

The securities act of 1933 provides that in certain cases of untrue statements or omissions of statements which should have been made, certain persons "may, either at law or in equity, in any court of competent jurisdiction, sue" an accountant who has prepared or certified any part of the registration statement.

(a) Explain what is meant by equity and how it differs from law.

(b) What is the most common remedy obtainable only in equity?

Answer:

(a) The subject of equity jurisprudence is one of great variety and extent. Probably the most striking and distinctive feature of courts of equity is that they can adapt their decrees to all varieties of circumstances which may arise and so adjust them to all the peculiar rights, mutual and adverse, of all the parties in interest, whereas in courts of law a general and unqualified judgment only may be given, which must be for the plaintiff or for the defendant without any adaptation of it to particular circumstances.

(b) The most common remedy obtainable only in equity is injunction.

No. 10 (10 points):

Define briefly the following terms (do not discuss or give examples):

(a) last will and testament
(b) legacy
(c) testamentary trustee
(d) principal of trust
(e) life tenant
(f) remainderman

Answer:

(a) Last will and testament—A disposition of real and personal property belonging to the maker to take effect after his death.

(b) Legacy—A bequest of personal property made by a last will and testament.

(c) Testamentary trustee—A person in whom some estate, interest or power in or affecting property is vested for the benefit of another by effect of appointment in a last will and testament.

(d) Principal of trust—I do not know what this means unless principal as distinguished from income.

(e) Life tenant—A person who holds an estate for the duration of his life. Sometimes definition includes one who holds for the life of some other person.

(f) Remainderman—A person who is entitled to the remainder of an estate after a particular estate taken out of it has come to an end.

No. 11 (10 points):

(a) Define and differentiate condition precedent and condition subsequent.
(b) Define and differentiate representation and warranty.

Answer:

(a) A condition precedent is a fact (other than mere lapse of time) which, unless excused must exist or occur before a duty of immediate performance of a promise arises. A condition subsequent is a fact which unless made inoperative will extinguish a duty to make compensation for breach of contract after the breach has occurred. The former must exist or occur before any rights arise under the contract; the latter operates to extinguish those rights that have arisen under the contract.

(b) A representation is a statement proffered as a basis for a contract, but instead of being a part of the contract it is collateral to it. A warranty is a statement upon the literal truth of which the enforceability of the contract depends. A representation precedes and is not part of the contract and need be only materially true, while a warranty is part of the contract and must be strictly fulfilled or the contract is unenforceable. A warranty must be strictly true; a representation need only be substantially true.

No. 12 (10 points):

Edward Brown was secretary of Charles Brown, Inc., and owned one quarter of its capital stock, and his father owned three quarters of it. This corporation was engaged in the grain business in the middle west. In 1922, the corporation was adjudged an involuntary bankrupt, Edward Brown was adjudged a voluntary bankrupt, and each was discharged from existing debts. Thereafter Edward Brown made a contract with another corporation to buy grain for it on a commission basis. In order to reëstablish his standing and credit and revive business relationships with former customers of Charles Brown, Inc., he personally paid most of the business debts of Charles Brown, Inc., which had been discharged in bankruptcy. Can Edward Brown deduct these payments from his commission income on his federal income-tax returns for the years in which he made the payments?

Answer:

Edward Brown can not deduct these payments on his income-tax returns. The only theory on which the deduction can be allowed is that these payments were ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Although it be assumed that the payment is "necessary" it can not be said that the payments were "ordinary." These payments were made to reëstablish a good financial reputation and are not ordinary expenditures; on the contrary, they are more like capital expenditures.

Correspondence

TREASURY SHARES

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: During the last year and one half many articles have been published in regard to the balance-sheet display where a corporation is the owner of its own shares of stock. The discussion originally was started by articles which were written early in 1933 by Robert E. Payne working with the Chicago Bar Association in drafting the new Illinois business corporation act, and by Anson Herrick, who was working with Professor Ballantine in the drafting of the California act.

Since that time articles have been appearing more and more frequently until in the August issue of THE JOURNAL there appear three different articles and one letter all dealing with this subject.

It seems to me that in the beginning there were two very distinct "camps" but that now all writers are gradually approaching a common meeting ground. Articles such as the one by Henry Rand Hatfield in the August issue will do much to bring the question to a happy conclusion although many readers of Mr. Hatfield's article may have experienced an unsatisfied feeling because of having expected the "old master" to draw more definite conclusions indicating more definitely his exact feeling in the matter. In general it seems to me that most of the other authors have been too busy arguing the point as to whether accountants should recognize legal concepts or not and have forgotten the main issue at stake. It seems to me that whether we should or should not recognize legal concepts depends entirely upon the question of adequate and proper as well as complete display of important facts. To show the cost of treasury shares as a deduction from capital and surplus combined or surplus seems to me to accomplish many things which other forms of display do not accomplish. For example:

1. It may be arranged distinctly to disclose the amount issued and outstanding in the hands of the public.
2. The total stated capital, which is not shown by other methods of display.
3. The cost of the treasury shares owned, which is not shown by most of the other methods of display.
4. It avoids a fictitious capital surplus, which may or may not be realized, depending on whether the corporation later sells or cancels the stock.
5. It at least indicates by showing the cost of the shares, the amount by which surplus may be restricted for the payment of future dividends.

It seems to me, therefore, that the deduction of the cost of treasury shares owned from capital and surplus combined or from surplus does everything that any other method of display does and does some other things which are of vast importance.

Yours truly,

C. C. HALE

Chicago, Illinois, August 21, 1934.

Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

EXPENSES ON PROPERTY ACQUIRED THROUGH FORECLOSURE

Question: An institution of a charitable and educational nature has its funds invested in bonds and mortgages which include a certain proportion of real-estate first mortgages. Let us say that most of the real-estate mortgages were acquired in 1928 or prior thereto and the face amount did not exceed 60 per cent. of the fair appraised value at that date, and in most cases the fair appraised value today is considered to be considerably in excess of the mortgage.

There is a question as to the proper handling of taxes paid, repairs and other expenses where it has been necessary to acquire the properties. As the institution will ultimately sell the properties acquired, is it not proper to add all taxes, repairs and foreclosure expenses paid to the cost of the property?

In certain instances there has been an assignment of rentals with the authority given the institution to make necessary repairs or alterations where required. In a case of this kind where the outlay is in excess of the rentals received in closing the accounts at the end of the year, the institution carries this excess as an account receivable from the mortgagor and if it afterwards becomes necessary to acquire the property, this amount would be added to property cost.

The institution also sets up an account for "Advances on properties under foreclosure" and includes in this account expenditures made until such time as property is finally acquired, when the amount is added to the cost of the particular property.

In preparing financial statements the balance in this advance account would be included as part of the property cost.

Answer No. 1: Your letter indicates that your correspondent is an institution of a charitable and educational nature. It is therefore apparent that the income-tax regulations and rulings may be considered as secondary to what may be considered as sound accounting principles in this case.

It is clear that the foreclosure of property represents an exchange of indebtedness of the previous owner for an equity in the real estate acquired by the foreclosure proceedings. On such exchange, the property acquired should be recorded at its fair value when received and if it is reasonably considered that such fair value equals the amount of the mortgage, plus accrued interest thereon together with back taxes and other expenses of foreclosure, the property may quite properly be recorded at the total of such amounts. On the other hand, if a conservative appraisal of the property would be less than this figure, the property should be taken over at the appraised value and the difference should be written off.

In the case of rent assignments it is proper to consider any excess of expenses over income as a charge against the mortgagor until the property is foreclosed or title thereto acquired. At this time the same procedure should be followed as outlined above for foreclosures of property generally.

Answer No. 2: It is our opinion that the treatment proposed is quite supportable in accordance with approved procedure.

In reaching this conclusion it is noted that in most cases the fair appraised value today of the properties acquired is considered to be considerably in excess of the mortgage and, we take it, such value has been established by recognized authority. We assume further that the exceptions are relatively unimportant.

DETERMINATION OF EARNINGS AND SURPLUS WITH REGARD TO DIVIDENDS

Question: I would appreciate what information you can give me on a question involving good accounting practice in the determination of earnings and surplus and the right of directors to declare dividends.

A corporation with no-par-value stock with a book value of say $10,000,000 has an operating deficit of $2,000,000. It is proposed to change the no-par-value capital stock to stock having a par value totaling $4,000,000, transferring the balance of $6,000,000 to surplus. Against this surplus would be charged the operating deficit of $2,000,000, leaving a surplus of $4,000,000.

Assuming that the company in its next year of operations loses $1,500,000 and in the following fiscal year makes $1,000,000 in net profits, can the directors at the close of the second year declare a dividend of say $600,000 out of the net profits?

Would it be good accounting practice to charge against the initial surplus of $4,000,000 after the reorganization of the capital structure the first year's loss from operations of $1,500,000, reducing the surplus to $2,500,000 and if this is done can that in effect be considered the final result of all previous years' operations, and can the company in effect start afresh with the following year, in which we are assuming earnings of $1,000,000, and pay a dividend of $600,000 out of those earnings without paying any attention to the operating deficit of earlier years?

In asking this question I am assuming that all necessary legal details have been covered, and the only answer desired is as to accounting practice usual in such cases and whether there would be a technical accounting objection to the payment of this dividend of $600,000 out of the profit of $1,000,000.

I realize the distinction that should be made between capital surplus and earned surplus, but would like an opinion as to whether it would be technically correct to charge the first year's operating loss against the capital surplus (which would be the only surplus then existing), leaving the balance of capital surplus at the net figure of $2,500,000, and whether it would be proper to set up the earned surplus at the end of the second year at $1,000,000 for the earnings, less the $600,000 of dividends paid out of those earnings, or a net surplus from earnings of $400,000. Is it, on the contrary, necessary to have the earned surplus represent the accumulated history of the company from the beginning, showing the accumulated results from earnings, less any dividends paid from earnings, ignoring the facts of proper legal charges of operating deficits against capital surplus?

Answer No. 1: We do not think it would be good accounting practice to charge against the initial or capital surplus of $4,000,000, the first year's loss from operations of $1,500,000. On the contrary, we think that the capital surplus should be carried forward in one account, and the loss on operations should be carried forward in the balance-sheet in a separate account. We do not believe that the net amount of $2,500,000 can be considered as representing the final result of all previous years' operations. The remainder of the question in which it is assumed that in the subsequent year earnings of $1,000,000 are realized and a dividend of $600,000 paid out of those earnings, presumably is a legal, rather than an accounting, question, inasmuch as the applicant inquires whether this dividend can be declared "without paying any attention to the operating deficit of earlier years." However, he goes on to say that the only answer desired is as to the accounting practice usual in such cases, and whether there would be a technical accounting objection to the payment of the dividend of $600,000 out of the profit of $1,000,000. We know of no accounting objection to showing the dividend as being paid out of the profits and, indeed, without a resolution of the directors to the contrary, we think that from an accounting point of view the dividend would be considered as having been paid out of the current year's profits.

We understand that the New York stock exchange for some time past has requested that listed companies show in their balance-sheets the earned surplus representing the accumulated results from operations, less any dividends paid therefrom. Therefore, in the event that the previous operating deficit of $2,000,000 is charged against the capital surplus, we think a notation to that effect should be carried forward in the balance-sheets for succeeding years.

Answer No. 2: The question as to whether or not a company can pay dividends when there is an operating deficit at the beginning of the year is a legal question, to be settled under the laws of the state in which the company is incorporated.

The accounting question involved is what, in the circumstances, the balance-sheet should disclose. It is our opinion that at the close of the period in which the change of stock from no par to par value is made, the transfer from capital-stock account to surplus and the charge against surplus of the operating deficit should be clearly shown. It is assumed that proper corporate action would have been taken about these items. If the company, in its next year of operations, loses $1,500,000 and the directors of the company formally authorize the offsetting of such loss against the capital surplus account, this should be clearly shown in the report for the year. If in the following year the company makes $1,000,000 in net profits and the directors legally declare dividends of $600,000 out of such net profits, it is our opinion that the surplus of net profits over dividend should be shown in the balance-sheet as earned surplus, provided it was designated as "earned surplus from January 1, 193–."

Answer No. 3: Fundamentally the rules are, or were, simple and it was safe to say that dividends could be declared only out of the accumulations of earned surplus; capital could not in any circumstances be encroached upon and had to be held intact. This simple rule, however, has been invaded in recent years by statutory changes in many states, particularly where there is no-par stock or stock of a nominal or stated value, the surplus in excess of such stated value being, even when of the nature of paid-in surplus, available for distribution in dividends. This, however, does not alter the economic error involved in the paying of dividends out of paid-in or capital surplus and, broadly speaking, the correct accounting practice should follow the economic law. In accounts, however, it is impossible to ignore the statutory law, and where statutes permit the payment of dividends out of paid-in capital the accounting officers can only bow to the statute, making clear, however, the facts.

If a deficit should, however, have accumulated in the past so that the capital is actually impaired, the correct procedure would be, particularly in the case of a par-value stock, to go through the formalities necessary to reduce the capital stock and, provided the facts were made clear to the stockholders taking such action, the surplus arising from such reduction could with propriety be used to wipe out the deficits referred to effecting, for all practical purposes, a reorganization and starting the profit-and-loss and surplus account anew from zero.

Applying these rules now to the particular problems enunciated in your communication, and of course having in mind that what may be here stated is subject to modification by reason of special state laws, it would appear that it would be entirely proper to reduce the capital from $10,000,000 to $4,000,000, but the balance of $6,000,000 should, strictly speaking, be transferred to capital surplus. As, moreover, this capital surplus of $6,000,000 is distinctly, it is assumed, made available for the liquidation of past losses, the accumulated operating deficits of $2,000,000 could then be charged against it, which would leave a surplus of $4,000,000. This, however, should be regarded as a capital surplus and not, generally speaking, available for division in the form of dividends or even for the liquidation of later losses, although if a special provision were made for the utilization of the $4,000,000, or any part of it, to liquidate later losses, probably to the extent of such provision passed upon by the stockholders, no exception could be taken. The statutory and legal rights of creditors would, however, have to be properly secured.

The propriety of permitting each year's transactions to stand on its own basis so that dividends be declared out of the surplus earnings of any one year, irrespective of whether a deficit is brought forward from prior years or not, opens up another question and the law in various states and countries is not uniform. The local law must, of course, govern, but again looked upon as a purely accounting question I would not regard it good practice to declare dividends if there is an accumulated balance of operating deficit still unliquidated, with the exception, of course, that after a reorganization, or what amounts to a reorganization, there would be propriety in starting, as I have already indicated, once more from scratch, ignoring all previous deficits wiped out by the reorganization.

Current Literature

(Compiled in the Library of the American Institute of Accountants)

AUDITING

Independent Audits

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